TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

JANUARY 31; FEBRUARY 1, 2; MARCH 14, 15, 1989

PART I

Serial 101-10

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
97-929 WASHINGTON : 1989

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

H781-54

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TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

TUESDAY, JANUARY 31, 1989

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press release announcing the hearings follows:]

FOR IMMEDIATE RELEASE
TUESDAY, DECEMBER 6, 1988

PRESS RELEASE #30
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE
BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A SERIES OF HEARINGS ON THE TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, announced today that the Committee will hold a series of hearings on the tax policy issues with respect to mergers, acquisitions, leveraged buyouts and recent increases in corporate debt, generally. The first three days of hearings will be held on January 31, February 1, and February 2, 1989, beginning at 10:00 a.m. each day, in the main Committee hearing room, 1100 Longworth House Office Building.

In announcing these hearings Chairman Rostenkowski stated: "The purpose of these hearings is to conduct a comprehensive review of leveraged buyouts and other forms of corporate mergers and acquisitions. The Committee wants to determine the effect of these transactions on the companies being purchased and the financial institutions and other investors who are providing capital for the purchases, and to examine the long-term consequences of the dramatic increase in corporate debt. In addition, the Committee will review the implications of these transactions for a tax system which should be fair to all Americans. Of particular interest to the Committee is the degree to which the tax code encourages and facilitates the financing of these purchases, as well as large increases in debt, generally.

"The Committee's concern about these issues is long-standing. In 1985, the Subcommittees on Oversight and Select Revenue Measures conducted hearings on junk bonds and the tax aspects of corporate acquisitions and mergers. In 1987, as part of the deficit reduction legislation, the House of Representatives adopted a Committee proposal to limit the deductibility of interest on debt incurred to finance corporate takeovers. I find it ironic that many of the harshest critics of that proposal are now calling for government intervention in this area. In addition, the House-passed version of the Tax Reform Act of 1986 contained a provision, ultimately dropped in conference, that provided an incentive for equity formation through a corporate dividends-paid deduction.

"The Committee is also sensitive to the concern that the Congress should be very careful about legislating in this area. The government should not try to substitute its judgement for that of the marketplace. On the other hand, when the prices of long-stable stocks nearly double in a matter of days, and when corporate equities are being replaced by massive corporate debt, it is fair to ask if the market, alone, is sufficient to the task of promoting economic security and stability. It is also appropriate to ask if these transactions allow certain corporations to escape the payment of fair taxes, thereby harming the average American taxpayer.

"The sheer size and number of recent acquisitions argue for Congressional review. The record amount of debt being incurred in these transactions poses an enormous risk for financial institutions, pension funds, and other institutional investors. It is appropriate to ask if these newly structured corporations will be able to service their debt in any future economic downturn, or in a period of rising interest rates. In addition, some corporations are greatly increasing their own debt. Wall Street and Washington have a responsibility to objectively analyze this trend to assure that the domestic equivalent of the third world debt crisis is not being created."

SCOPE OF THE HEARINGS:

It is anticipated that the first two days of hearings will consist of testimony from witnesses invited by the Committee, including government policy makers, corporate leaders, tax practitioners, academicians, and other analysts. In addition, the Treasury Department is expected to be invited to testify.

Public testimony is invited for additional hearings which will follow. Testimony is requested by the Committee on the following issues:

1) Tax policy concerns raised by recent transactions, including the implications of the replacement of equity with debt, the impact on economic stability, the effect upon corporate tax receipts, the involvement of tax-exempt investors, including pension plans, ESOPs, and others, the involvement of insurance companies, the involvement of foreign investors, and the role of banks and savings and loan institutions;

2) Possible legislative options responding to these tax policy concerns, including proposals to reduce the present bias toward debt;

3) Proposals designed to encourage incentives for equity formation, such as the dividends-paid deduction provision contained in the House-passed version of the Tax Reform Act of 1986.

Specific dates and times for additional hearings will be announced in a subsequent press release.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard by telephone to Harriet Lawler or Diane Kirkland [(202) 225-1721] no later than Wednesday, January 4, 1989, to be followed by a formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Committee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee staff [(202) 225-1721].

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearings. (See formatting requirements below.) In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

(MORE)

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Committee are requested to submit 200 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of the scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearings should submit at least six (6) copies of their statements by the close of business on the date two weeks after the date of the last hearing on this issue (to be announced in a subsequent press release) to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearings wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Committee office before the beginning of the last day of the hearings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

* * * * *

FOR IMMEDIATE RELEASE
WEDNESDAY, FEBRUARY 8, 1989

PRESS RELEASE #1
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES THE CONTINUATION OF HEARINGS ON THE TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, announced today that the Committee will continue its series of hearings on the tax policy issues of mergers, acquisitions, leveraged buyouts and increases in corporate debt generally on Tuesday, March 14, and Wednesday, March 15, 1989, beginning at 10:00 a.m. each day, in the main Committee hearing room, 1100 Longworth House Office Building.

In announcing the continuation of these hearings Chairman Rostenkowski stated: "Our first three days of hearings on January 31 and February 1 and 2, 1989, provided Members of the Committee with a wide variety of opinions and a tremendous amount of information from government policymakers, academics and other experts. I look forward to receiving further testimony during these additional two days of hearings on the complex economic and tax issues regarding transactions which increase corporate debt."

BACKGROUND:

On December 6, 1989, Chairman Rostenkowski issued a press release announcing hearings on the tax policy issues of mergers and acquisitions and corporate debt. Individuals and organizations interested in presenting oral testimony before the Committee were asked to submit requests to be heard by January 4, 1989. On January 31, February 1 and February 2, 1989, the Committee held three days of hearings on these issues, receiving testimony from witnesses invited to testify before the Committee. On March 14 and March 15, 1989, the individuals and organizations who requested to testify before the Committee will be heard. It is anticipated that these two days of testimony will conclude the public hearings on this subject at this time.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons who wish to submit written statements for the printed record of the hearings should submit at least six (6) copies of their statements by the close of business on Wednesday, March 29, 1989, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearings wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Committee office before the beginning of the last day of the hearings.

Chairman ROSTENKOWSKI. As much as possible, we would like all our guests to find seats.

The committee will come to order.

Today the Committee on Ways and Means begins a comprehensive review of issues related to mergers, acquisitions, leveraged buyouts, and other transactions that result in corporate equity being replaced by debt.

The numbers and trends are very alarming. Since 1983, over $313 billion of corporate equities have been retired by nonfinancial corporations, while borrowing has increased by $613 billion.

These issues are not new to this committee. In 1985, the Subcommittees on Select Revenue Measures and Oversight held hearings on junk bonds and the tax aspects of corporate acquisitions and mergers.

In 1987 as part of the deficit reduction legislation, the House adopted a committee proposal to limit the deductibility of interest on debt incurred to finance corporate takeovers.

I find it ironic that barely a year after that proposal was soundly criticized and rejected, the outcry for Congress to review this area has become deafening.

In addition, the House-passed version of the Tax Reform Act of 1986 contained a provision ultimately dropped in conference, that provided an incentive for equity formation through a corporate dividends-paid deduction. Part of the review we are undertaking here today is to consider a variety of options which would equalize the treatment of debt and equity by the Tax Code.

Although the committee should and will be cautious in legislating in this area, the recent movement toward increased leveraging of corporate America's balance sheets demands our immediate attention. We want to hear why there has been such an enormous increase in the number and size of these deals.

Is it the phenomenal growth of the junk bond market, the rise of the arbitrage game or the incredible fees which can be earned by investment banks, advisers and underwriters? Or is it the substantial tax advantage in substituting debt for equity?

It is appropriate for the committee to ask whether these trends allow certain taxpayers to avoid their fair share of the corporate tax burden. Allowing the free market to operate in a manner which promotes economic stability and growth is a good thing; but allowing the marketplace to be manipulated by financial engineers taking advantage of the Tax Code is not.

In these hearings, we will ask whether the level of debt in some recent takeovers and LBO impairs the ability of leveraged corporations to service their debt, particularly during an economic downturn or in a period of rising interest rates.

We will also explore the implications for expenditures for research and development and capital improvements.

It is important for this committee to look at the aftereffects of these LBO's and takeovers, which often result in the sale of significant parts of some companies.

Are employees losing their jobs with devastating impacts on their communities? Much of the money invested in these transactions comes from banks, savings and loans, pension funds, insurance companies and other institutional investors, which are investing on behalf of individuals. We must determine whether these investments pose undue risks to the future retirement and welfare of those individuals. We will also ask whether such risks are too great for the future soundness of our banking system, another issue of critical concern to this committee.

It has been suggested that the recent trend of substituting debt for equity is simply the marketplace successfully accomplishing integration and the avoidance of the two-tier tax system.

It is critical that we determine what erosion of the corporate tax base and Federal revenues is resulting from this trend. Clearly, our current budget deficit cannot allow such erosion.

While considering these issues, the committee is sensitive to the issue of the competitiveness of U.S. companies in our global economy.

It is important that foreign companies not be advantaged over U.S. companies. We are also aware that any proposals restricting investment which are considered must include an analysis of U.S. treaty obligations as well as transitional problems which arise in the treatment of prior investments.

In the next 3 days, we are scheduled to hear from a long list of distinguished witnesses who we hope will inform and educate us on those important issues which have commanded our attention early in this Congress.

In addition, the committee expects to hold further hearings on these issues in March as well as hearings at a later date in the Oversight Subcommittee on the pension aspects of leveraged buyouts and the issue of foreign investment in the United States.

We welcome as our first witness, the Secretary of the Treasury, Mr. Nicholas Brady. Before calling on Secretary Brady, I yield first to my friend and ranking member, Mr. Archer.

Mr. ARCHER. Mr. Chairman, thank you very much.

Today as you mentioned, we begin a series of hearings examining the use of debt by corporations and the long-term consequences to our American economy. The issues before us are exceedingly complex.

I believe it is appropriate that we proceed deliberately and cautiously in determining if an appropriate legislative response exists, particularly from this committee. It is possible that the leveraging of corporate America we have witnessed in recent years has been spawned at least in part by certain basic structural idiosyncrasies in our Tax Code.

Dividends paid by corporations are not deductible. This creates a double tax since income is taxed once to the corporations and again to the shareholders. In contrast, interest payments by corporations are deductible.

Other recent changes in the Tax Code such as the repeal of the General Utilities doctrine and the repeal of the capital gains differential may have further favored the use of debt over equity.

In particular, the repeal of capital gains differential eliminated an important advantage of equity. It is perfectly understandable that sometimes corporate managers would respond to the current tax laws by substituting debt for equity.

It is unfortunate that Congress did not adopt the corporate dividends paid deduction advocated by the administration in 1985 and adopted by this committee in the House passed version of the 1986 Tax Reform Act. I believe that integrating the corporate income tax along the lines adopted by our major trading partners would have gone a long way in reducing the current growth in corporate debt. I look forward to hearing from today's array of distinguished witnesses. In particular, I would like to join Chairman Rostenkowski in welcoming Secretary Brady in his maiden appearance before this committee as Treasury Secretary.

I have enjoyed meeting with you, Secretary Brady, on prior occasions. I look forward to working with you as we grapple with the issue of escalating corporate debt levels and other problems the committee will address this year.

Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Secretary, welcome. I am looking forward to a long, long honeymoon. I am sure that you recognize, as we do, the burdens facing this administration. We hope we can be of help in solving them.

STATEMENT OF HON. NICHOLAS F. BRADY, SECRETARY OF THE TREASURY

Secretary **Brady**. Thank you, Mr. Chairman.

I want to thank you for inviting me up here today to testify on this all important issue. I would note that as Secretary of the Treasury in the Bush administration, this is my first appearance before the House, and I am just delighted that it is with the Ways and Means Committee. This may be viewed as a good indication of what President Bush has told me and all members of the administration, that he wants to consult Congress and have an open line of communication.

If it is agreeable with you, what I would like to do is read a greatly shortened version of my prepared statement.

Chairman **Rostenkowski**. Without objection, the entire statement will be included in the record. You may summarize.

Secretary **Brady**. It is a pleasure to be here today to discuss with you the growing phenomenon of leveraged buyouts, LBO's, and related transactions. The effect of LBO's on the American economy has become a matter of increasing concern both to Wall Street and Main Street as the size and number of LBO's have grown.

One recent transaction approached $25 billion in size, suggesting that, if anything, the pace of LBO activity continues to accelerate. The business sections of our newspapers and nightly TV stock market reports abound with stories of the returns earned by investors in LBO's.

As might be expected, that level of success attracts additional capital. There is now an estimated $30 billion in funds organized for equity investments in LBO's, which, when expanded by the associated debt, would support between $250 and $300 billion in future LBO's. The availability of such capital generates its own demand, as the pressure on managers to invest their assets spawns a search for new LBO candidates.

These hearings provide an opportunity to develop the data we need in order to reach an informed judgment on how LBO's have affected the American economy. Given what is at stake, we should proceed carefully, sort out the evidence, and insure thorough consideration of what is a complex subject.

In examining the LBO phenomenon, we should not restrict our concern to LBO's alone. Just as investors pool their funds to create LBO equity funds, companies using the equity in their own operations leverage themselves up in order to engage in exactly the same activity. I call these transactions leveraged takeovers, LTO's. As a matter of simplicity, in the course of my testimony I will address my remarks to LBO's, although they should be read to include LTO's as well.

Perhaps the issue that should guide our analysis of LBO's is the competitive position of the U.S. corporate sector. Increasingly, we find ourselves in a global economy, with American businesses under pressure to compete and maintain the markets for their products. Their ability to remain competitive is, of course, central to our economic future. If we are competitive in the world economy, we will be able to provide the standard of living that our citizens desire and the jobs that they deserve.

We ought, therefore, to focus on whether LBO's and the changes they produce in corporate financial structures hurt or improve our competitive position. That same standard should also be applied to measures which might be proposed to regulate LBO's in the future.

Thus, even if we conclude that LBO's have adversely affected the corporate sector, we should weigh carefully whether proposals to restrict LBO activity will, in fact, aid American business, or only make more difficult the competitive challenges we face.

Part of the LBO strategy relates to the tax system, and its discriminatory treatment of equity versus debt. Since interest payments are deductible but corporate dividends are not, there is an advantage that accrues to LBO's and other transactions that substitute corporate debt for equity.

I would underline the following: It should come as no surprise that removing the burden of a 34-percent tax rate from a corporation's income stream can arithmetically increase the value of a corporation's capitalization.

Substitution of interest charges for pretax income is the mill in which the grist of takeover premiums is ground. However, as I have said in my longer written statement, I do not believe the recent surge in LBO's should be seen as driven only by tax considerations. Tax incentives on debt capitalization are long standing, and legislation may have diminished the tax benefits available from leveraged acquisitions.

However, tax considerations remain an important part of corporate financial planning, and we should be concerned about the tax system bias against equity. Because we subject income on corporate equity to double taxation while interest payments are taxed only once, a corporation is encouraged to raise capital in the form of debt rather than equity.

A new corporation is encouraged to load its initial capital structure with debt. The growing corporation is encouraged to raise new capital through debt. The mature corporation is encouraged to replace its existing stock with debt, either through a stock buy-back or an LBO.

Many have concluded the way to correct the tax bias for debt capitalization is to limit corporate interest deductions. This approach, however, would simply increase the cost of capital for American acquirers by raising their interest rates on an aftertax basis. Since such restrictions would not affect the borrowing costs of foreign corporations, the net effect would be a disadvantage for U.S. corporations.

Finally, the long history of attempts to define problems out of existence has proved that the definees are more adept than the definors. Just as soon as new regulations are written, efforts are underway—usually successful—to render them irrelevant.

Perhaps a more logical approach to the biases in our tax system would be to focus on our overtaxation of corporate equity.

We stand virtually alone in the industrial world in the extent to which we apply a double taxation regime to corporate income. Thus, although each of our major trading partners imposes a separate taxation on corporate income, most also provide substantial relief from that tax when dividends are distributed.

We should not ignore the fact, as we are every day forced to compete in an increasingly global economy. Germany, Italy, and Australia allow shareholders full credit for corporate taxes paid. France provides full relief through the combination of a partial deduction for dividends paid and a partial shareholder credit. Other countries, including Japan and Canada, provide significant partial relief from double taxation.

My testimony has been necessarily general, but I feel we are headed in the wrong direction when so much of our talent and resources are aimed at financial engineering when the rest of the world is laying the foundation for future growth. We have always done our best in this country when our savings have been used to create new jobs, new products and new services at lower prices. LBO's produce fundamental changes in the financial structure of this country's corporations. They raise basic questions about our economic future, whether we will continue to grow and create jobs and whether we will remain competitive.

Mr. Chairman, I know you and the members of this committee share my concerns. By holding this series of hearings, you have issued a call to the brightest minds in both government and the private sector to combine and evaluate this trend.

I commend your efforts. I would like to join you today in this endeavor by issuing a challenge to those who make the financing decisions and the financial institutions which advise them. I call on them to put the same intensity and effort into evaluating where we are going as they have in taking us there. Let them bring forward the evidence and make proposals about what should be done.

It is entirely proper, in fact, important that we together, Congress and the administration, call upon the private sector to take on this responsibility. After all, it is in the finest tradition of our system that government look first to the people themselves for solutions and only act when it becomes clear that the people cannot solve the problems themselves.

Thank you, Mr. Chairman.

[The statement of Secretary Brady follows:]

Text as Prepared
Embargoed for Release Upon Delivery
Expected at 10 a.m., EST

Testimony By
The Secretary of the Treasury
Nicholas F. Brady
Before the Committee on Ways & Means
of the U.S. House of Representatives
Tuesday, January 31, 1989

Mr. Chairman and Members of the Committee:

It's a pleasure to be here today to discuss with you the growing phenomenon of Leveraged Buyouts (LBOs) and related transactions. The effect of LBOs on the American economy has become a matter of increasing concern both to Wall Street and Main Street as the size and number of LBOs have grown. One recent transaction approached $25 billion in size, suggesting that, if anything, the pace of LBO activity continues to accelerate. The business sections of our newspapers and nightly TV stock market reports abound with stories of the returns earned by investors in LBOs. As might be expected, that level of success attracts additional capital. There is now an estimated $30 billion in funds organized for equity investment in LBOs, which, when expanded by the associated debt, would support between $250 and $300 billion in future LBOs. The availability of such capital generates its own demand, as the pressure on managers to invest their assets spawns a search for new LBO candidates.

In examining the LBO phenomenon, we should not restrict our concern to LBOs alone. Just as investors pool their funds to create LBO equity funds, companies using the equity in their own operations leverage themselves up in order to engage in exactly the same activity. I call these transactions Leveraged Takeovers -- LTOs. As a matter of simplicity, in the course of my testimony I will address my remarks to LBOs, although they should be read to include LTOs as well.

I. OVERVIEW

Competitiveness. Perhaps the issue that should guide our analysis of LBOs is the competitive position of the U.S. corporate sector. Increasingly we find ourselves in a global economy, with American businesses under pressure to compete and maintain the markets for their products. Their ability to remain competitive is, of course, central to our economic future. If we are competitive in the world economy, we will be able to provide the standard of living that our citizens desire and the jobs that they deserve. We ought, therefore, to focus on whether LBOs and the changes they produce in corporate financial structures hurt or improve our competitive position. That same standard should also be applied to measures which might be proposed to regulate LBOs in the future. Thus, even if we conclude that LBOs have adversely affected the corporate sector, we should weigh carefully whether proposals to restrict LBO activity will, in fact, aid American business, or only make more difficult the competitive challenges we face.

Need for More Data. The Committee will hear much testimony on the effects of LBOs. Some contend that LBOs reflect ordinary market forces and result in a more efficient corporate structure with improved investment of industrial resources. Others see a pattern of increasingly risky transactions, a sign that LBO activity, as with prior speculative markets, has begun to spiral out of control. They foretell a series of overpriced, overleveraged transactions, leaving the corporate sector increasingly vulnerable to an economic downturn.

These hearings will enable the Committee to get beyond much of the rhetoric that surrounds LBOs to examine and develop the data we need in order to reach an informed judgment on how LBOs have affected the American economy. Given what is at stake, we should proceed carefully through the evidence, and ensure thorough consideration of what is plainly a complex question.

II. BACKGROUND

LBO Structure. The typical LBO involves the acquisition of a public corporation by a small investor group, frequently including the target corporation's management and/or one of the LBO funds that pool capital for this purpose. The investors would ordinarily operate through a shell acquisition corporation, which would either merge with the target or make a tender offer for its stock. In either event, the target shareholders would surrender their equity, common stock, for cash and/or debt of the acquisition corporation.

The equity supplied by the investor group typically represents 15 percent of an LBO's total capitalization. Around one-third of an LBO's total capital would be subordinated debt, initially in the form of bridge loans which would later be replaced with so-called junk bonds. The bridge financing (roughly 30 percent) often comes from an investment bank, with the junk bonds purchased by pension funds, specialized limited partnerships, insurance companies, bank subsidiaries and tax-exempt institutions. The largest part (roughly 55 percent) of the total LBO financing would ordinarily be debt secured by the assets and receivables of the target corporation. This senior debt would typically come from a syndicate of banks, but may to a smaller extent involve insurance companies and specialized limited partnerships.

Corporate Trends. The surge in LBO activity in recent years can be seen as the convergence of two trends in the structure and capitalization of American corporations. The first, and more fundamental, is the replacement of corporate equity with debt and the consequent leveraging of corporate balance sheets. This trend is in part a product of LBOs and similar transactions such as LTOs. Independent of an acquisition, however, a corporation may repurchase its outstanding stock with indebtedness or with cash attributable to indebtedness. LBOs are, however, a principal occasion for corporations incurring new indebtedness, and many corporations that have issued debt to repurchase stock have done so as a defensive maneuver to head off a possible LBO or LTO.

The growing number of LBOs also represents a trend toward privatization of formerly public corporations. The movement by large U.S. corporations to operate privately rather than through public equity markets would not necessarily be a matter of concern. Private ownership frees a corporation from the pressures and the short-term perspective of the stock markets and may well be a prudent strategy, depending on a corporation's business and its need for investment capital.

III. LEVEL OF ACTIVITY

LBOs. The significance of the corporate trends toward additional leverage and private ownership is reflected in recent data concerning LBO activity. From 1978 to 1983, the total value of LBOs was around $11 billion dollars. In the five years since, LBOs totaled $160 billion, with 1988 alone accounting for over $60 billion.

The data also reveals a lesser trend of LBO activity concentrated in industries better able to support substantial leverage. Thus, a disproportionate share of LBOs have occurred in nondurables manufacturing, retailing, and services, all relatively noncyclical industries with characteristically strong cash flows.

Corporate Debt. An analysis of individual LBOs suggests that these transactions have introduced unprecedented levels of corporate leverage. Thus, the level of debt in some recent LBOs leaves the corporations unable to service their debt with existing cash flows. It is becoming apparent that many such transactions require immediate asset sales at higher prices in order to reduce the debt to a manageable level. In other cases, the corporation will be required to cut back on non-interest expenditures; for example, expenditures for research and development and replacement of capital goods, in order to provide an effective debt retirement schedule.

The extreme leverage in recent LBOs is only partly reflected in aggregate data concerning corporate debt. Most balance sheet measures of corporate debt indicate a significant increase in leverage over the past few years, with current levels at a historical high. Other measures, however, suggest more moderate increases in leverage. For instance, if debt and equity are taken at market rather than book value, current leverage ratios, although rising, remain well below the peak levels of the mid-1970s, and are in line with the average over the last fifteen years. This is consistent with the ratio of net interest expense to cash flow, perhaps the most accurate measure of a corporation's ability to service its debt. The ratio, although currently rising, remains below the peak levels reached in the early 1980s.

Ultimately, however, the significance of corporate leverage is a question of individual corporations' capacity to service their debt. Aggregate data concerning debt ratios reflect averages. And just as one may drown in water that averages two feet deep, average debt ratios cannot answer whether there are significant individual situations of dangerous overleverage. It is important to know whether individual cases of extreme leverage are isolated, and perhaps attributable to special circumstances, or reflect instead an accelerating trend in American industry.

Data addressing these and related questions is being developed at Treasury and by some in the private sector. We should recognize, however, that past experience is not a particularly good measure of the future prospects for a highly leveraged corporation. Existing LBOs have thrived in a period of extended economic expansion. They have not been subjected to the test of leaner times. It is certainly not the policy of the Bush Administration to arrange such a test. But how well these highly leveraged entities survive can not be answered by past data alone.

IV. CAUSES FOR CURRENT LEVEL OF LBO ACTIVITY

Some view LBOs as a rational strategy to maximize the value of corporations and their assets. Part of this strategy relates to the tax system and its discriminatory treatment of equity versus corporate debt. Since interest payments are deductible, but corporate dividends are not, there is a substantial tax advantage that accrues to LBOs and other transactions that effectively substitute corporate debt for equity. It should come as no surprise that removing the burden of a 34 percent tax rate from a corporation's income stream can arithmetically increase the value of a corporation's capitalization. The substitution of interest charges for pre-tax income is the mill in which the grist of takeover premiums is ground.

In addition, LBOs may generate new efficiencies in corporate management and financial structures. For corporations in mature industries, where cash flows are strong but opportunities for internal growth limited, an LBO may be a logical mechanism for distributing excess cash resources, allowing the market to reinvest the funds in more productive activities. Similarly, LBOs in some cases force corporate managers to abandon unproductive investments or extraneous lines of a corporation's business. Thus, some have seen in LBOs and the divestitures they trigger a process of corporate deconglomeration, reversing the conglomerate merger activity prevalent in the 1960s and early 1970s.

Although tax and efficiency considerations may be an important part of an LBO, they do not fully explain the extent and timing of LBO activity. The tax advantages of debt capitalization have existed for most of the history of the corporate income tax. Some analysts believe that the changes in the 1986 Tax Reform Act, including the reduction in the corporate tax rate and the elimination of the so-called General Utilities doctrine, may actually have diminished the tax benefits available from leveraged acquisitions.

Similarly, there does not appear to be anything in recent corporate management that would have suddenly made LBOs attractive. On the contrary, the corporate circumstances that arguably permit efficiency gains as a result of an LBO predate by a number of years the surge in LBO activity.

In sum, viewing LBOs as transactions that maximize shareholder value does not explain why it is only in the last few years that LBO activity has taken off. So what has happened? Our own analysis suggests that other factors have contributed importantly to the development of LBO activity at its current level. In part, these factors, which I will discuss here, have simply facilitated a market in which LBOs were made feasible.

Junk Bond Market. A key factor in the increase in LBO activity is the emergence of a junk bond market, which has supplied much of the debt capital on which LBOs are based. Prior to the late 1970s, junk bonds were generally fallen angels -- obligations that had been of investment grade when issued but were later downgraded because of problems that had arisen with the issuer's credit. More recently the junk bond market has developed into a market for corporate debt that, because of the debt's subordinated status and the corporation's substantial other indebtedness, is below investment grade when issued.

A central purpose of the present-day market for junk debt has been to facilitate directly LBOs and LTOs. The substantial leverage characteristic of LBOs dictates that much of the debt capital will necessarily be of an extremely junior grade. In the past, neither banks nor the traditional bond markets provided for such transactions and consequently, an alternative source of financing evolved. In sum, the junk bond market has vastly facilitated increased LBO and LTO activity.

Arbitrageurs. The current volume in LBOs is also partly attributable to the growth in arbitrage activity. Arbitrageurs purchase the stock of corporations thought to be acquisition candidates, hoping to sell the stock at a higher price if and when the acquisition is concluded. By definition, arbitrageurs are not long-term investors, and the nature of their activity and the demand for high rates of return on their available capital require that they turn over their investments in a reasonably short period of time. Because of arbitrage activity, the perception that a corporation is "in play" tends to become a self-fulfilling prophesy. Once arbitrageurs buy up the stock of a corporation, the willingness of the corporation's shareholders to sell is established, and management's ability to resist an acquisition is effectively reduced. The certain knowledge that arbitraguers own working control of the target company's stock in turn makes sure that the potential acquirers bidding for the corporation's stock will succeed.

Bargain Stock Prices. A third factor responsible for recent LBO activity is the perception that many stocks remain undervalued. As LBO and LTO operators have come to focus on the value placed on a corporation by the stock market, as compared with the replacement cost of its assets, and the higher sales values of component parts, the opportunity for bargain purchases has become apparent.

Strong Economy/Speculative Returns. Much of the current momentum behind LBO activity may simply reflect that, to this date, prior LBOs have largely been successful. Many have questioned whether the same pattern of success would have developed if the economy had been less robust in the last several years. At the moment, however, investors do not seem discouraged by such concerns, since they have rushed to get in on the spectacular returns that some prior LBOs have generated.

Advisory Fees. A final contributing factor in the proliferation of LBO activity is the ability of investment advisers, banks, underwriters and LBO fund managers to earn substantial up-front fees in the transactions. Such fees can total nearly 6 percent of the corporation's purchase price, and lend considerable momentum to LBO activity. These fees are earned up front, largely divorced from the long-term risks in the transaction. The LBO sponsor, investment banks, bond underwriters, syndicating bank and others earn substantial income if an LBO is completed, and thus have strong incentives to identify LBO candidates, arrange financing, and conclude transactions. Sadly these same parties may have relatively little, if any, investment in the long-term success of the new enterprise. Given this arrangement, it may very well be that the net effect of LBOs is a financial snipe-hunt, where the new long-term investors, flashlight in hand, are left holding the bag.

V. THE EFFECTS OF LBOs ON THE CORPORATE SECTOR

Corporate Management. LBOs have been defended by some as a positive check or discipline on corporate managers. In some cases, LBOs may well correct some of the deficiencies in the formal mechanisms of corporate governance. Our system of corporate democracy provides for a balance between continuity and change although it is viewed by some as exceedingly difficult for management of a public corporation to be removed by shareholder vote. Thus, management, once established, may pursue growth policies that aggrandize the corporation's position, but do not necessarily maximize the shareholders' investment. An LBO can be viewed as a sanction of such policies, since it replaces old management with a new team.

The entrenchment of corporate managers, free of effective control by the shareholders, may be a matter of legitimate concern. I find it difficult to accept, however, that LBOs and the psychology that feeds them are a sensible form of corporate governance. As the pace and scope of LBO activity have grown, I fear we are reaching a point where management is simply not disciplined toward more productive investment, but is robbed of any ability to pursue policies not in step with current market attitudes. In particular, to the extent markets become preoccupied with current earnings and cash flow, managers lose the flexibility to pursue long-term investment strategies. At a minimum, the corporate manager that pursues growth at the expense of short-term earnings may be threatened with the loss of his company.

We should not be surprised if corporate managers choose not to run that risk, and instead embrace what is currently fashionable, even though not in the long-term interest of their corporations. If that attitude becomes prevalent, we should be concerned whether U.S. corporations will make the commitment to research and development and other growth oriented strategies necessary to maintain their future competitiveness in a global economy.

We should also recognize that the plight of the corporate manager may not be relieved by privatization of the company. A buyout of a corporation's public shareholders does free it of stock market pressures, and thus in theory permits the corporation to pursue growth oriented policies without regard to the short-term effect on its earnings or stock price. As a practical matter, however, we are concerned that the financing in a typical LBO leaves management still focused on short-term performance, since substantial cash flow must be generated simply to meet debt service requirements.

Vulnerability to Business Cycle. The cash flow burdens of substantial leverage make a corporation more vulnerable to cyclical movements in the economy or to periods of slow economic growth. Debt service that may be manageable in periods of economic growth may become unmanageable if a corporation's revenues fall. Some argue that LBO debt can be restructured in the event of a downturn. Where a bankruptcy is forced, however, there may be significant costs in lost jobs, forced sales, and distraction of management. Moreover, the costs of bankruptcy may extend to the government, which effectively guarantees certain of a corporation's pension obligations for defined benefit plans through the Pension Benefit Guaranty Corporation.

Corporations and their lenders obviously take some account of bankruptcy potential, and what level of debt is prudent remains dependent on a particular corporation's situation. The many individual instances in which an LBO has dramatically increased a corporation's leverage, and the apparent market acceptance of these transactions, suggest that corporate managers and the financial markets have placed greater emphasis on the benefits than the risks of leverage. This attitude may be attributable to the sustained economic growth of the last six years, which has permitted the optimistic assumptions that appear to underlie some transactions to remain untested.

Risk to Banking System/Financial Institutions. The risks attributable to increased corporate debt fall also on investors. Some level of risk is inherent in all investment, and there would seem to be no reason for concern where individuals or business investors knowingly undertake the risks involved in acquiring LBO debt. However, much of the capital invested in LBOs comes from banks, savings and loans, pension funds, insurance companies and other institutional investors which are in effect investing on behalf of the individuals whose savings they control. It should be noted that depositors in banks and savings and loans and participants in defined benefit pension plans have the benefit of a federal guarantee of their deposits.

Many observers have questioned whether LBOs are appropriate investments for financial institutions, given the levels of risk involved. Although there is an understandable desire on the part of such institutions to maximize returns on their invested capital, such desires must be balanced against their fiduciary obligations to avoid substantial commitments of capital to high risk investments. This concern is sharpened by a history of overcommitment, driven by fees and fashion, to types of loans which subsequently proved to be problems.

In this regard, a number of state insurance regulators have proposed restrictions on the extent to which insurance companies can hold such debt. I am also encouraged to see that Chairman Greenspan of the Federal Reserve Board and Comptroller of the Currency Clarke have indicated their intent to review carefully the level of LBO investments by federally chartered banks.

Fairness to Shareholders. A concern expressed by some is whether LBOs permit Wall Street insiders and corporate managers to profit at the expense of ordinary investors. This is a legitimate concern, but one which was more relevant in the early days of LBO transactions.

More recently, however, we have seen that in most cases the market will operate to ensure that shareholders receive full value for their stock. As we have witnessed in recent transactions, a management initiated LBO may trigger offers from outside interests, with the ultimate price for the company's stock determined in an auction-like bidding process. This process works best to establish a fair price when all bidders have access to the relevant information concerning the corporation's business. And, corporate boards of directors, with the encouragement of the courts, have tended to insist that the corporation's books be opened to all potential bidders.

Other Constituencies. A final but important area of concern is the effect of LBOs on corporate constituencies other than the shareholders. In previous testimony to the Senate I have cautioned that we should be careful not to march to the drumbeat of single dimension philosophies. Thus, while shareholders may realize large premiums from an LBO, the corporation's employees, bondholders and the communities in which the corporation is located may all be adversely affected. Employees may lose their jobs if the corporation is forced to retrench or if divisions are sold in order to retire debt. Such job losses have significant collateral effects on the communities in which the employees work.

The clearest losers from a financial viewpoint in some LBOs are the corporation's pre-existing bondholders. The drop in the corporation's credit rating translates directly into a reduction in the value of their bonds. However, this is arguably a situation where the affected can take care of themselves, since a variety of contractual devices are available to protect bondholders in the event of an LBO or similar transaction affecting the corporation's credit rating.

VI. REMEDIAL MEASURES

A. Tax Proposals. As I indicated earlier, I do not believe the recent surge in LBOs should be seen as driven only by tax considerations. The tax incentives for debt capitalization are long standing, and recent legislative changes may have actually diminished the tax benefits available from leveraged acquisitions. However, tax considerations remain an important part of corporate financial planning, and we should be concerned about the tax system's bias against equity capitalization.

Because we subject income on corporate equity to double taxation, while interest payments, like wages, are taxed only once, a corporation throughout its existence is encouraged to raise capital in the form of debt rather then equity. The new corporation is encouraged to load its initial capital structure with debt; the growing corporation is encouraged to raise new capital through debt; and the mature corporation is encouraged to replace its existing stock with debt either through a stock buyback or LBO.

Dividend Relief. Many have concluded that the way to correct the tax bias for debt capitalization is to limit corporate interest deductions. This approach, however, would simply increase the cost of capital for American acquirers by effectively raising their interest rates on an after tax basis. Moreover, since such restrictions would not affect borrowing costs of foreign corporations, the net effect would be a competitive disadvantage for U.S. corporations. Finally, the long history of attempts to define problems out of existence has proved that the definees are more adept than the definors. Just as soon as new regulations are written, efforts are underway to render them irrelevant.

A more logical approach to the biases in our tax system would focus on our overtaxation of corporate equity. We stand virtually alone in the industrial world in the extent to which we apply a double tax regime to corporate income. Thus, although each of our major trading partners imposes a separate tax on corporate income, most also provide substantial relief from that tax when dividends are distributed. We should not ignore this fact as we are every day forced to compete in an increasingly global economy. Germany, Italy, Australia, and New Zealand allow shareholders full credit for the corporate tax paid. France provides full relief through the combination of a partial deduction for dividends paid and a partial shareholder credit. Other countries, including the United Kingdom, Japan and Canada, provide significant partial relief from double taxation.

The Treasury proposals for Tax Reform in 1984 and 1985 would have reduced the tax burden on corporate equity by permitting corporations to deduct a portion of the dividends they distribute. The House of Representatives included a scaled-back version of these proposals in its 1985 Tax Reform bill. Although dividend relief was eventually dropped in the final Tax Reform legislation, we should not accept this as the last word on the merits of such proposals. I well recognize that at this juncture revenue considerations limit our ability to provide fundamental relief from double taxation of corporate income. But the fact remains that market forces have created their own solution to the double taxation of dividends. At the same time, tax as well as economic policy would be ill served if we were to address the current imbalance in the taxation of debt and equity without seriously considering proposals to mitigate in some significant way the double tax on corporate equity income.

Revenue Effects. Part of the concern with the tax incentive for leveraged acquisitions and stock repurchases relates to possible revenue losses from a broad substitution of debt for existing corporate equity. A corporation replacing nondeductible dividend distributions with deductible interest payments will of course achieve a savings in its income tax liability for many years. If such substitution were to occur on a broad scale, there would be a correspondingly large reduction in corporate income tax receipts.

It is important to recognize, however, that LBOs and leveraged share buybacks typically generate three effects offsetting the increase in corporate interest deductions. An LBO or stock repurchase represents a taxable sale of stock for shareholders, generally at a substantial premium, and the gains recognized effectively accelerate income that might have been deferred for a number of years, or even exempted altogether if the shareholder held the stock until death. In addition, an LBO or substantial share repurchase would typically require taxable asset sales by the corporation in order to retire indebtedness. It is also important to recognize that to the extent that LBOs or other leveraged recapitalizations lead to a more efficient allocation of resources, the overall level of national income will be increased, and this will generate additional tax revenues which will further offset the adverse revenue impact of the substitution of debt for equity by those transactions.

B. Financial Institution Regulation. The substantial fees that banks can command for arranging LBO financing, as well as the higher interest rates they can charge, may lead some banks to commit an inappropriately large portion of their portfolios to LBO debt. Moreover, there is concern that some of the banks participating in a syndicate do not examine the loans carefully and simply rely on the judgment of the lead bank. Chairman Greenspan's recent warning to banks that they should examine closely the prospects of LBO loans under a wide range of economic and financial circumstances is thus particularly apt.

C. Securities Law. An additional and important source of regulation is the securities laws. In a recent testimony before the House Telecommunications and Finance Subcommittee, SEC Chairman David Ruder outlined several regulatory changes being considered by the SEC. Among the most important is a discussion of the rules governing so-called fairness opinions. In this regard, a standard practice that should receive scrutiny is linking the size of the fee paid for the opinion to successful completion of the transaction. Such linkage raises serious questions as to the objectivity of the opinion.

VII. CONCLUSION

My testimony has been necessarily general, but I admit that I have a growing feeling that we are headed in the wrong direction when so much of our young talent and the nation's financial resources are aimed at financial engineering while the rest of the world is laying the foundation for the future.

We have always done best in this country when our savings have been used to create new jobs, new products, and new services at lower prices. LBOs produce fundamental changes in the financial structures of this country's corporations. They, in turn, raise basic questions about our economic future, whether we will continue to grow and create jobs and whether we will remain competitive.

Mr. Chairman, I know you share my concerns. By holding this series of hearings, you have issued a call to the brightest minds in both government and the private sector to examine and evaluate this trend.

I commend your efforts and I would like to join you today in this endeavor, by issuing a challenge to those who make the financing decisions and the financial institutions which advise them -- to the gladiators in the arena.

I call on them to put the same intensity and effort into evaluating where we are going as they have into taking us there. Let them bring forward the evidence and make proposals about what should be done.

I think it is entirely appropriate that we together -- the Congress and the Administration -- call upon the private sector to take on this responsibility. It is in the finest tradition of our democratic system that government look first to the people themselves for solutions and only act when it is clear the people can not solve the problem themselves.

Chairman **Rostenkowski**. Thank you, Mr. Secretary.

Mr. Secretary, you stated that you think one reason for the recent increase in corporate debt and reduction in equity is the marketplace successfully integrating the two-tier corporate tax system. What are your preliminary thoughts regarding legislating in this area?

Secretary **Brady**. Well, Mr. Chairman, we do not have a concrete suggestion to offer you today. I would only offer the idea, as I have publicly before, that if it is determined that a solution is needed what we aim to do is perhaps balance the system.

In other words, if you were going to make a change, and the Treasury is not suggesting one, but if you were going to make one, we would suggest that you look into the area of perhaps limiting interest deductions but use that money, the money so generated, to give a break to corporate owners of stock who are doubly taxed, thereby trying to bring the values of those two securities more into balance.

Chairman **Rostenkowski**. Would you suggest a shareholder credit for equity relief?

Secretary **Brady**. That could be a good idea.

Chairman **Rostenkowski**. Mr. Archer?

Mr. **Archer**. Thank you, Mr. Chairman.

Mr. Secretary, in your opinion, to what extent is this LBO situation that we are confronting today a result of the low savings rate of the people of this country, as I understand it, the lowest perhaps in all our history?

Secretary **Brady**. Mr. Congressman, I would give more weight to the fact that the LBO phenomenon really has invented a new way of creating value. It is very simple. If you take the 34 percent that used to go to the Federal Government, to the Treasury, and add that to the amount of money that a corporation can pay to a new group of shareholders and bondholders, you can create a higher value.

In the system that prevails in most industries today, where we have a balance between equity and debt, in order to get dividends to pay to shareholders, you have to pay the Government 34 percent. In the typical LBO, all pretax income is extinguished. The percent that used to go to the Government goes to a new class of holders.

Arithmetically, if you took the premiums paid in the market and LBO activity, you can nearly prove that they are the 34 percent that used to go to the Government. So, I think that is the driving force.

Mr. **Archer**. What is the general debt-equity ratio of corporations in this country today, compared to—historical comparison—to the last 20 years?

Secretary **Brady**. It is inching up. It still hasn't reached an alarming proportion in the Treasury's mind. The LBO activity as my testimony and others will state—has only been in evidence about 3 or 4 years. So, it still is a small part of the corporate structure in the United States.

However, debt ratios have gone up; not to alarming proportions, but they are higher.

Mr. ARCHER. What happens to the capital that is represented by the equity values that are realized from an increase in the sale price of corporate stock? In other words, we are concentrating on the area of, say, junk bonds that are used for the purpose of these LBO's. But there is a commensurate, additional value in the corporate stock.

Somebody gets that money. Now, what happens to that money?

Secretary BRADY. Well, I think the question you raise is a good one. I think there are two answers. One, when I say that the Treasury's corporate revenues go down because the interest deduction eliminates taxable income, at the same time when capital gains are created, the Treasury's income goes up, because the holder of the stock sold at a higher price pays a tax on the money he receives from that transaction.

Also, in terms of macroeconomics, the money that he or she receives from selling his or her stock goes back into the system. It depends where it goes. If it goes into a new growth company, new jobs are created, and that is good. If it goes back into the cycle of takeover activity, more takeover activity goes on.

So, I think from a macro point of view, nothing is lost to the system. It goes back in the system. All that is good. It depends where the money goes next.

Mr. ARCHER. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Secretary, you have asked individuals engaged in this merger and LBO activity to come forward and share with you the analysis of proposals that they would suggest in this area. Since you first made this statement, Mr. Secretary, have you received any significant assistance from the industry?

Secretary BRADY. Well, in a general way, Mr. Chairman, yes. I think that the people that I have called into the Treasury have generally responded to that call. But I haven't had any specific suggestions.

Frankly, I am a little disappointed.

Chairman ROSTENKOWSKI. Mr. Pickle may inquire.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Secretary, we have a serious problem here. Mr. Rangel's Subcommittee on Select Revenue Measures and my Subcommittee on Oversight, over 3 years ago, held a hearing on mergers and acquisitions. We were looking at tax aspects involved as well as how to attack the problem of junk bonds. We couldn't get anything done, I think largely because nobody wanted to touch it. The attitude in the administration at that time was to let the big eat the little and the little eat the big. Everyone said we ought not to get into this, because not all mergers and acquisitions were bad, which is true. So we coasted along. The problem has gotten bigger. The Joint Taxation Committee shows me today, in the last 3 years, the total of mergers and acquisitions has averaged at a total dollar value of about $170 billion.

In the area of leveraged buyouts, they tell me the dollar value in 1987 had gone up to $35 billion from about $18.8 billion. So this problem is not getting better. It is not getting easier.

You have said one answer might be to reduce the interest deduction and maybe allow the deduction on dividends.

My question to you is, If that is a good idea, what percentage of dividends would you allow to be deducted? Would you say 50 percent?

Secretary Brady. I am sorry? I didn't hear the punch line of your statement.

Mr. Pickle. You said we could maybe reduce the amount of interest of deductibility and also give a deduction on the dividend side. How would you balance the two? Would it be 50-50?

Secretary Brady. Well——

Mr. Pickle. What percentage would you say?

Secretary Brady. Congressman, I hadn't really focused on what percent that—such a revision in the Tax Code might take. I think you are hitting right at the hard part of it, which is how do you define this? That is one of the reasons why we have not come forward with an estimate? It is very hard to define how you do this.

Mr. Pickle. I am hoping, Mr. Secretary, that we start having specific suggestions, from the Treasury that we can consider, that are factual and not just a generality. I have said perhaps 50 percent. I am trying to find a way to take the Tax Code out of mergers, acquisitions, and LBO's.

My question, then, to you overall would be, Is it possible to develop an overall tax structure that would be entirely neutral with respect to reorganization incentives?

Secretary Brady. Well, so far, we have not been able to come up with one. We were hoping that somehow these hearings might provide the kind of basis for making that kind of a decision.

Mr. Pickle. I don't want to be argumentative. But it seems to me like that is a kind of kiss done through a veil. It doesn't help us very much. I would hope as we go along, we get something specific that would be helpful to us.

Now, I think part of your problem, we were told, is you don't have the manpower to audit these LBO's. IRS stated they are totally unmanned. Last year, last fall, one IRS official said that IRS can't audit LBO's because it can't hire experts. It can't hire anybody. It doesn't have the resources. Your own Commissioner said you had a budget gap of around $300 to $500 million. Is that true?

Secretary Brady. I am unfamiliar with that testimony, Mr. Congressman.

Mr. Pickle. I am going to tell you it is a fact. What is your response to that? Your own Department now is making that statement. How do you plead?

Secretary Brady. If we have such a gap, Mr. Congressman, we will take a look at it and get back to you. I wish I had the answer, but I don't.

Mr. Pickle. I don't want to be unpleasant about it. We are reaching the point where we need to be more than pleasantly general about something. We have to try to be more specific.

Let me ask you a question: How many completed LBO deals has the IRS audited in the last 3 years?

Secretary Brady. I will get back to you with that.

Mr. Pickle. Mr. Secretary, you just are generalizing with me again. I am trying to find out from you. Can't you give me some general figures about how many LBO's have been audited?

Secretary **Brady**. There wouldn't be any point. I don't know the answer to the question. A general answer isn't sufficient.

Mr. **Pickle**. I think I know part of the answer.

Secretary **Brady**. I appreciate that.

Mr. **Pickle**. I understand there have been less than 10 LBO's audited in the last 3 years and completed. Is that correct?

Secretary **Brady**. I do not know. I will find out and get back to you.

Mr. **Pickle**. Ask one of your experts in back of you.

Secretary **Brady**. The experts don't know.

[The following was subsequently received:]

The IRS has advised us that there are more than 70 large corporations currently under audit that have participated in LBO transactions. Unfortunately, we do not have information on the number of taxpayers participating in LBO transactions that have been audited over the past 5 years.

The IRS currently audits taxpayers rather than transactions and thus does not examine leveraged buyout transactions as such. An LBO would be examined only if a taxpayer under audit had participated in the LBO, and even then the focus of the examination would be on the aspects of the LBO that relate specifically to the taxpayer under audit. The IRS is studying further how it might improve its audit procedures with respect to LBO transactions.

Mr. **Pickle**. I was going to ask somebody to go under oath. Since you don't know, there is no point in putting someone under oath about that.

Well, I am disturbed that I don't seem to have any specifics. You have just come on to this job, but you are not a neophyte. We ought to start being more specific.

We acknowledge all mergers and acquisitions are not bad. Some of them are good and do help. But if the Tax Code is being used to promote these big mergers, then these big LBO's and merger could not increase much productivity as a general rule.

There may be exceptions. Most do not. In my view, they are destroying the system. It has been claimed in the RJR Nabisco deal, that the buyout amounted to $25 billion alone. And Forbes magazine said the loss in that field is $500 million in lost revenue to the taxpayers.

Is that essentially correct?

Secretary **Brady**. The size of the acquisition was about $25 million. There will be obviously, when the company is reconstructed, a diminution of income that comes to the Treasury because of the size of the income tax deduction. That is correct.

Mr. **Pickle**. Let me ask you one more question. A New York Times article said that the RJR——

Secretary **Brady**. I didn't hear you.

Mr. **Pickle**. A New York Times article said investors in the RJR Nabisco deal identified several prestigious universities and other exempt organizations that are participating in the buyout funds. These include Harvard, MIT, and the Salvation Army.

My own university might be involved in it. Are there any special risks to exempt organizations in these deals?

Secretary **Brady**. Well, there are risks in leveraged buyout transactions. The people that buy the securities should realize that those securities are much more risky than the average bondholder's stock. I presume all of the pension funds that you have mentioned, and I hope including the Salvation Army, have trustees who understand what the ERISA laws mean when they say they should be prudent about taking these risks.

Mr. PICKLE. Do you have any idea if those tax-exempt organizations pay unrelated business income tax?

Secretary BRADY. I do not know.

Mr. PICKLE. Would you ask your staff to try to give us some figures on tax-exempt involvement in LBO's? Could you advise us if they are paying UBIT?

[The following was subsequently received:]

With respect to exempt organizations participating in LBOs, we do not have any specific information on the number of audits or on whether they are paying UBIT with respect to income generated by their participation in such transactions. Form 990T, the form on which exempt organizations report unrelated business income, would not indicate whether any UBIT is attributable to the exempt organization's participation in an LBO.

We would not, however, expect exempt organizations to become subject to UBIT as a result of participating in LBOs. In general, UBIT does not apply to an exempt organization's interest and dividend income or its gains from the sale or exchange of property. Under current law, if an exempt organization participates in an LBO through owning either a debt or an equity instrument, its income from the investment would be subject to UBIT only in the unusual situation of the organization having borrowed to make the investment.

Mr. PICKLE. I notice Alan Greenspan has warned that we ought to control or stop, cut back on the use of pension funds and/or banking institutions in the participation on these junk bonds or leverage buyouts. Do you agree with that?

Secretary BRADY. Mr. Pickle, I don't know if that is exactly what he said. I think both the Office of the Comptroller of the Currency and the Fed are instructing their regulators as they go and examine banks to make sure that these institutions have proper documentation for the purchase of the securities that they make, particularly including securities that arise out of LBO transactions.

The Comptroller of the Currency has promulgated those regulations. I am told by Chairman Greenspan just this morning that the Fed is studying the same kind of a procedure.

Mr. PICKLE. I think the committee ought to have a restatement made of what Mr. Greenspan has said. In your own testimony you mention that as a very definite precaution we ought to take. The question is can these tax-exempt organizations continue to participate in LBO's and invest in junk bonds? Should they?

Are their pension funds at risk? Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Stark will inquire.

Mr. STARK. Mr. Secretary, in answer to a question about Mr. Archer, I think you suggested that although we lose some revenue on the interest deduction side of this transaction, we pick it up when people have to liquidate assets to pay off the loans and they have a gain in those, so we pick up capital gains tax to offset the interest deduction?

Secretary BRADY. What I said was that we do lose the money that used to come from the corporate tax, but when a person sells a security to take advantage of the premium he receives in an LBO premium offer, he pays a capital gains tax, which is now a current income.

Mr. STARK. The subsequent sale of any assets, if the aggregate sale of assets by the buyer is higher than what they paid, that also would generate some tax?

Secretary BRADY. That is correct.

Mr. STARK. Then on the subsequent sale by the buyer, if we lowered the capital gains tax rate, we lose revenue on that transaction from what we receive now?

Secretary BRADY. If that capital gains tax lowering were applied to those kinds of assets, sure.

Mr. STARK. On the original premium offer, lowering the capital gains rate would have one of two reactions. It either would increase the activity because people would be less reluctant to sell; or, two, lower the revenue to the Treasury. Is that not correct?

Secretary BRADY. That is correct.

Mr. STARK. In general, lowering the capital gains tax rate would not have a good effect on the whole issue of leveraged buyouts.

Secretary BRADY. It depends on whether that increases people's willingness to sell. At the same rate you are losing income. It depends how that turns out.

Mr. STARK. Thank you.

Chairman ROSTENKOWSKI. Mr. Frenzel will inquire.

Mr. FRENZEL. Mr. Secretary, thank you for your testimony today. Usually before we legislate, the committee is under the impression that there is a fairly serious problem out there. Did your studies prove conclusively to you that the problem is serious and imminent?

Secretary BRADY. Mr. Congressman, no, not at all. I think the conclusion that I have, and I think the President shares it, is that I have a gnawing feeling that so much of our young talent in this country, and so much of our savings, is aimed at financial engineering; that it could very well hurt us badly in the world economy, where other countries are furthering long-term plans. That is No. 1.

No. 2 is that we have done the best in this country when our savings are used to create jobs, lower the cost of goods, and produce higher quality goods; and that you have this feeling as you read the papers every day that the preoccupation with this kind of activity in the long run and—if extended and if it grew at a faster rate—is going to lead us somewhere we don't want to go.

You cannot prove at this point in time that the economy has been damaged. Certain sectors have, but not the economy as a whole.

Mr. FRENZEL. We reach the conclusion that we need to make some changes by philosophy and existential feeling rather than by hard evidence that there is some deterioration as a result of these LBO's? Is that correct?

Secretary BRADY. Yes.

You can't prove at this particular point in time that the economy has been damaged by those things.

Mr. FRENZEL. You at the moment have no concrete recommendations for this committee or other committees of the Congress?

You expect to be working on the problem?

Secretary BRADY. We do.

Mr. **Frenzel**. Is it your expectation that you will have a hard program for us at some point perhaps this year?

Secretary **Brady**. Congressman, I would say this. At this particular point in time it seems to me we are at a crossroads with regard to LBO's. We have a habit in this country of correcting things we think are wrong just as they are about ready to correct themselves.

In my opinion, what we ought to do is watch a little longer. This is not something that is going to gobble us up in the next 2 months.

If the trend continues, then I think we ought to make some changes. I think the changes ought to be in leveling the playing field between how debt is taxed compared to equity.

Mr. **Frenzel**. Our problem is that we have a lot of committees in this Congress who operate in different jurisdictional playpens. All of us want to be heroic. Some of our heroism usually carries with it a variety of unintended results.

The only group that can at least focus on a broad approach with some kind of coherence is the administration since we are working in sync.

I hope you are going to be able to give us the advantage of your leadership rather than have us march off in a variety of directions when, a variety of unintended results would be likely to occur. At least that has been my experience.

So my query is, or my plea is, I guess, that this gets some good, solid thinking by the administration so that you can either lead us in the right direction or protect us from ourselves so we don't get too wild in solving a problem that we feel is a problem.

I think we all feel it is a problem, but it is very hard for us to define. That is not really a question and maybe not something to comment on.

But I would like you to comment on the fact that if the problem is, indeed, a debt/equity problem, as you feel it is, and I do, too, I am wondering why there have been no suggestions to enforce some of the rules that we presently have on the books?

The Fed has a regulation which prevents certain margin acquisitions which the Fed believes should be handled in court with an aggrieved private party taking on the other, but which, I guess, the SEC has suspected might be something that it could enforce; neither of them at the moment are enforcing.

We at least have one regulation on the books available which nobody wants to use. I don't know if you want to comment on this? But if you don't, I just suggest while we are looking for solutions we might well look to existing regulations which at the moment have no method of enforcement, which have denied private recourse, and which our regulatory agencies at the moment are reluctant to enforce or feel there may be some problem with enforcement.

Mr. **Pickle**. Would the gentleman yield?

Mr. **Frenzel**. I yield.

Mr. **Pickle**. The gentleman from Minnesota has suggested we ought not to rush into this matter and propose some wild scheme, either by the Congress or by the Treasury. I think we would all agree that that is so.

I am disturbed, Mr. Secretary, that you would say this problem is nothing much more than an annoyance to you and to the President. The Joint Tax Committee has given us figures that the dollar value of these LBO's in 1987 alone has gone to nearly $36 billion.

For 1988, RJR Nabisco will be around $25 billion alone. The trend is going up and up and up.

Now we don't have to look at it as if a big MX missile is heading our way. But it is more than just swatting a gnat.

Your answers may encourage the big business out there to continue this trend instead of cutting back.

Secretary BRADY. Mr. Congressman, the word "annoyance" is your word, not mine.

What I said was that we had a feeling that this trend was not a good trend when the major talent in our country and our Nation's resources were aimed at it. That is not annoyance. That is a statement.

I have also said that this country has done better when its savings have been used to put in factories, create new jobs and create products at a lower price with higher quality. That is not a statement of annoyance. That is a statement of fact.

The reason why I can't get any stronger than that, which I think is strong, is that this trend is not so evident to somebody who looks at figures the way I do, that we should do something draconian about it, at this point in time.

We may have a difference of opinion.

Mr. PICKLE. Mr. Secretary, I don't intend to put words in your mouth. I thought you said you were quoting the President that he was "annoyed" this trend has developed.

If that is not the word you used, I think the record will reflect it.

Secretary BRADY. If I said "annoyed," that is not what I said in my statement. I withdraw the word, if you will allow me to do that, and have my original statement stand.

Chairman ROSTENKOWSKI. Mr. Ford will inquire.

Mr. Downey will inquire.

Mr. DOWNEY. Thank you, Mr. Chairman.

Mr. Secretary, I have a sense that we are looking at a richter scale, and it doesn't show anything. But the time it shows a 7 or 8 point eruption on it, it might be too late to do anything about it.

I guess I share yours and the President's and everyone else's "gnawing," I think, is what you said, concern about that?

Secretary BRADY. I did say "gnawing."

Mr. DOWNEY. Yes. I am glad we cleared that up.

I am a bit more concerned, however, about some of your statements. Not concerned in the sense that I disagree with them, but rather I agree with them.

I want to flush you out on some of them.

You said today there is no evidence that these deals have been harmful to the economy.

Can you think of any deals that you think by themselves were just bad deals in the process of fee-getting and churning that some of these people wanted to do, just to make fees, or were unbalanced, as you look at these deals, many of them in the interest of the companies that were taken over and, in fact, some of them have done better as a result of management shakeups?

Secretary BRADY. Well, Congressman Downey, you have stated the arguments. On the one side, people say nothing good is gained, large fees are paid, the corporate structure in this country is overleveraged with debt, and our institutions are buying securities they shouldn't buy.

On the other hand, the positive side of the argument is that, perhaps, the corporations in this country have come to need a system where they are aided in attaining new efficiencies.

When you put a new corporation in place with a lot of debt, there are a lot of peripheral things you can't do. You have to cut back on some of the things that may or may not be important. Advertising is one.

There are a lot of other surplus things that corporations may have done where leveraged buyouts can provide a new way of developing efficiency.

It depends on which side of the argument you want to take.

Mr. **Downey**. I endeavored in anticipation to these hearings to speak to people on both sides of this issue. It seems if you want to be guided by an anecdote, which we don't, you can make cases for the fact that some of the leverage buyouts have made a big positive difference for these people.

In turn, some of the people making the deals have gotten very rich doing it. It is on that point that I want to address what you mentioned was the President's concern and your's about that American talent going into this financial engineering. What is wrong with that?

Secretary **Brady**. What is wrong with it in my opinion, is that I just have a deep down belief in my stomach that this country does better when we are using our best talents out of all the law schools, business schools and colleges to lay plans for the future, make long-term plans and put the money in the ground, build plants, develop new products, try to lower the price and provide higher quality.

To me, we ought to be looking—if you want to talk generally about this—competing with our foreign competitors. When our Nation's resources are pointed that way—I feel very strongly, and so does the President—the country does better.

On the other hand, how you define it out of existence, I am not so sure.

No. 2, we have a habit in this country of curing problems, bringing a lot of regulations and laws just as they are about to go down the other side of the mountain.

I see us right now at a level where I am not sure that the private sector of this economy ought to be told people don't like it.

See if they can come up with solutions, and let's see whether this trend stops itself before we put in a lot of laws and regulations which increase the size of the bureaucracy, just at a time when the system is about to right itself.

Mr. **Downey**. I commend you for the idea that may be now is not the time to act.

The problem that I have is it appears as though the chairman has held hearings and the Senate has held hearings not just for the purpose of elevating the issue to public attention but rather to do something. That is typically why we have hearings.

The chairman mentioned to you, and I think you responded in the affirmative, that there was an idea, at least in your gut, that it would probably be better to do some of, the equation is too heavily skewed in favor of debt and not in equity.

Would it be unreasonable if the committee looked at a proposal that would limit part of the deduction for debt and use that money, in fact, for credit for dividends received or dividends given for corporations, deduction for dividends given?

Secretary **Brady**. I think that is a good idea.

The Treasury will do that as well.

Mr. **Downey**. You would say you would favor some limitation on the deduction of debt if it were to be applied in a direct one-for-one dollar transfer for making equity more favorably treated?

Secretary **Brady**. I would favor that as long as we understand that coming up with those definitions usually produces a whole host of people on the other side who are quicker at finding their way around those definitions than we are at putting them in place.

If we can get definitions that really make sense and that will hold, then I think that is a good idea. If we are into the same old problem of putting in an operation and finding out within 2 years somebody has run around them, I don't think that is such a good idea.

Mr. **Downey**. The only way to know that, of course, is to do it.

Can I ask you with respect to this transfer, if one assumed a 10-percent figure on the limitation of deductions was appropriate, would you have any favorite view of whether or not giving a credit to dividend holders or deduction to the corporation would be a more preferential method of equity enhancement?

Secretary **Brady**. We don't have a view as between those two alternatives.

Mr. **Downey**. Is the department looking at one that might be of some guidance to us?

Secretary **Brady**. We are reviewing the regulations in order to see if there is some system that can be defined and make sense. We have not pursued——

Mr. **Downey**. Based on your experience on Wall Street, the people that I met with were very bright and talented people, are not yet convinced that we have a way of inducing them to be structural engineers or electrical engineers.

My experience, and I don't mean to put words in your mouth, and please correct me if I am wrong here, that these people would ordinarily be doing something else. Clearly, the monetary rewards on Wall Street are well known to people who work at KKR or other places like that.

People are getting very wealthy, and they are very talented people, for the most part.

What other means do you have for us to try and channel their energy into something more as you consider valuable, building engineering talents?

How would you take these people and place them into other businesses?

Would we want to offer greater inducements in undergraduate school for engineering training?

What do we do to take that talent and rearrange it?

Secretary **Brady**. Mr. Congressman, I don't want to bore everybody to death by repeating what I said already. I think in the first instance we ought to say what our hearts and minds tell us, which is that this is not the way the youth in our country, the young, smart people should be spending their time. The rewards are very, very high.

I come from Wall Street. I know exactly what they are. It seems to me that we are headed in the wrong direction when our young talent, the best of our young talent is aimed at doing that. I can't do any more for you this morning than tell you that is how I feel.

How you turn something that is inside of your mind and heart into a tax law, that is the reason why I have not come forward with a proposal. That is very hard stuff.

Chairman ROSTENKOWSKI. Mr. Schulze will inquire.

Mr. SCHULZE. Thank you, Mr. Chairman. Thank you, Mr. Secretary.

Mr. Secretary, I share your concern with the business communities and yesterday's mentality. And I hope that over the next several years, even in a small way, we can have an impact on changing that thrust. I think it is important, as you have stated in the long run for the well-being of our Nation.

It seems to me that between your statement and the chairman's statement, you have spread the questions before us in a very able way. There are just not an awful lot of easy answers.

But as we look at LBO's, should we view this as an opportunity for revenue enhancement or should we not look at that angle at all?

Secretary BRADY. No, I think balancing where the committee comes out and where the Congress ought to come out and where the administration ought to come out is to look at the evidence, and it indicates so far that the revenue lost through interest deductions is pretty much offset by the revenue you get—it used to be called capital gains revenue, but is now taxed at the same rate as ordinary income—that those revenues seem to balance themselves.

That is what our studies have shown so far. So, from the revenue to the Treasury point of view, where the Government has the restrictions of Gramm-Rudman on its hands, you can't make a compelling case that great harm is being done.

Mr. SCHULZE. As we view this problem, should we see it as an opportunity for increased revenue, as an opportunity to bring in some additional revenue to help with some of those problems, or should we not look at it from that angle?

Secretary BRADY. The statistics that we see pretty much prove that it is dead level at this time, and you can't prove that it is either bringing in——

Mr. SCHULZE. If we are looking for a cure, there are ways that we can at least go after a cure which will bring in additional revenue.

Secretary BRADY. I think the cure is that if you could ever level the playing field between equity and debt, you wouldn't have to worry about it. I think we are dealing with the free market's reaction to the double taxation of dividends. It is pretty clear in my mind. You have a system whereby one way of capitalizing a company takes the 34 percent that used to go to the Government and gives it to security holders because they are not taxed doubly as they are if they do it by the traditional old way.

The way to do it is to try to level the playing field so that dividends have the same—that equity has the same chance as does debt. We should try to aim ourselves at being sure that the corporate structures in this country aren't induced to head that way.

The Tax Code now produces that kind of a result.

Mr. SCHULZE. It is somewhat of a widespread feeling that overfunded pensions create the ripe target for a takeover acquisition. Are they being utilized? Is this a way that we should view the problem and say, perhaps, place a restriction on the utilization or the withdrawal of funds from overfunded pensions for a period of time, 3 years, 4 years, 5 years, in an LBO so we take away that attractiveness of going after a company because it has an overfunded pension?

Secretary BRADY. I think there are examples of the case that you state, and we get back into the definition problem, how do you define it? But I think the main point here is that the pension obligation of a corporation is an obligation of the corporation as a whole.

A pension fund, as you know, Congressman, is a means by which you fund that liability. Our concern, it seems to me, should be focused on whether the pensioners get their money, and the pension fund is a method of funding it.

Mr. SCHULZE. So there is no way that you can think of that we might discourage the attractiveness of an overfunding? Discouraging a takeover?

Secretary BRADY. The ERISA laws cover the way pension funds in this country are organized. As a matter of fact, the Labor Department and the Treasury Department are holding a joint press conference today, where the Treasury and Labor will announce that they have reached an agreement to some changes in the language that give pension funds some instructions, some guidance so that they can look long term, and those same changes in the interpretations of ERISA's law will also say that pension funds don't have to take the quick buck. They can look long term, they are entitled to rely on the long-term plans of management.

So, I think that if the lawyers who now interpret these regulations, take a hard look at this, they will be able to advise the corporations that run their pension funds that they don't have to go into LBO's.

Mr. PICKLE. Would the gentleman yield?

Mr. SCHULZE. In a minute, Mr. Pickle, my time is limited.

Mr. Secretary, what extent have LBO's had impact on R&D? Do you see a detrimental impact? And is there something that we should look into a little more closely here?

Secretary BRADY. Well, you know, one's initial impression would be that because the LBO is so heavily capitalized with debt, that things such as R&D will be cut. The evidence does show that most of the LBO activity is in corporations with very low R&D expenditures.

Mr. SCHULZE. How about the LBO impact on interest rates and overall in our economy, in a macroeconomic sense?

Secretary BRADY. We can't discern that LBO's raise the interest rates in this country. The interest rates on LBO's are higher, but a market has developed so that people who want to make that investment, as well as others, are being taken care of in that area.

Mr. SCHULZE. I will be happy to yield now.

Mr. GUARINI. I want to wish you well as our Secretary of the Treasury, and coming from New Jersey, I take great pride in the role that you will be playing in our future. I am sure that you agree that we do need a very sober, careful analysis, that this is most important to our country, and that it affects our ability to compete, our ability to grow, in science and technology, research and our productivity.

I am wondering whether or not, listening to this discussion here, whether you feel that it is that the problem could be cured just by addressing the nontax aspects. Because every time we apply a change to our tax laws, we don't know what we unwittingly trigger off. There are unintended consequences, there are winners and losers, and sometimes I feel that we don't even have enough data base to be able to make a sound decision as to how we should change our tax laws.

Do you feel that this problem could be adequately addressed by just addressing the nontax aspects?

Secretary BRADY. Well, as my previous testimony, Mr. Congressman, indicates, I think that we do not need a change at this particular point in time. We are at the point where this is either going to be a trend we should watch more carefully or it will recede as a lot of market forces bring it down.

If we are going to make a change, and I am sorry for the lack of precision in this, I think we should look in the direction of leveling the playing field. That is as far as I have been able to get.

Mr. GUARINI. Would you put a cap on interest rates, floating so much above prime? I understand subordinate debt now goes for 30 to 50 percent. We had usury laws in our country, but they weren't flexible. I am just wondering whether or not to protect the equity of the stockholders if there should be a limit on how much a corporation in good health could pay for interest?

Secretary BRADY. I think we have to be very careful that we don't put rules on in this country, Mr. Congressman, which disadvantage our own corporations and in effect encourage foreign acquisition, and that is one of the problems in dealing with, you know, laws which place on our own corporations inabilities to act, while foreign corporations are free to act.

So one of the balancing facts here is how will it affect foreign corporations?

Mr. GUARINI. Now, I understand that our debt versus equity is now, in the last 5 years, the debt is up $600 billion, the equity is down $300 million. And other countries have a better balance than we have. We are just getting our corporate America in hock. I wonder what your view would be if a recession happens? How can we handle this if our ratio keeps getting worse, compared to the other developing countries that we are competing with, when we have a worsened debt position?

Secretary BRADY. Well, as my written testimony indicates, Mr. Congressman, the truth of the matter is that this trend has been rising during a time when we have had in this country a 72-, 74-month expansion. So, we do not have any experience as to how this will turn out should the wind change and instead of being at our back, be in our face.

So that is one of the things that obviously is troubling as you look at this trend. And I join you in worrying about that as one of the reasons why we ought to take a good, hard look at it.

Mr. GUARINI. Do you know whether or not the worst is behind us? What is out there in the future, in your estimation?

Secretary BRADY. Well, I hear that there is less of it going on the last month than there was earlier toward the end of 1988. But we can't prove that yet.

Mr. GUARINI. But you think there will be an acceleration? The country has been up so far. If you extrapolate, where would we be? Will there be an eventual leveling off? The big deals already resolved?

Secretary BRADY. I tend to think that there will be a leveling off. We should wait and see. We have had an enormous amount of big deals in 1988, and it could well be that the funds available for this type of investment are drying up.

Mr. GUARINI. Would you suggest any laws for the raiders to give special notice, longer notice, that the arbitrage people be handled differently to go after the raiders component in the equation?

Secretary BRADY. No, Mr. Congressman, I wouldn't. I don't know how to define it. If I knew how to define raiders as opposed to a corporation, there are corporations that are raiders, there are individuals that are raiders, there are foreigners that are raiders, so I think we get into a definition problem right away. I wouldn't know how to do that.

Mr. GUARINI. What about the arbitrage people, don't they play an important role in obtaining quietly the amount of necessary information and stock, and they are sort of like the inside people in putting together these kinds of deals?

Secretary BRADY. Well, the arbitrageurs, as my testimony is laid out, are an integral part of the LBO phenomenon. Again, if this committee feels, and we all conclude at the end of this testimony that that is something that should be looked at, then dealing with the arbitrageurs, is something that could be a way to go.

But I would caution you that this activity is a big part of stock—you know, the level at which the stock market sells. And we should be very careful that we don't indicate that this is something that is coming when we are not sure that it should come, because that could produce a big ripple in the market. I don't think we are to the point that we proved we ought to do that yet.

Mr. GUARINI. We know investment houses get up to 6 percent in putting a deal through, which is an extraordinarily high amount. I understand last year, it was something like a little under $1 billion in fees that were paid and they, of course, are encouraging the banks and savings and loan institutions get into this game. I don't want to spoil our day, but that is another problem, and the high rollers and the high riskers are out there with their greed.

Under those circumstances, I think we have a problem with the investment houses that we could limit as to what kind of fees they get to discourage these big deals from being made.

Chairman ROSTENKOWSKI. The time of the gentleman has expired.

Would you like to respond to that?

Secretary **Brady**. Yes. With regard to the size of the fees, you have two people on both sides of the fees, the people who receive them and the corporation that pays them, and to me, it is a little like a ho~~use sale.~~ I think the commission on real estate sales is about 5 percent. In Wall Street as elsewhere, fees are too large, competition will come in and drive them down, and I think that is what will happen.

Chairman **Rostenkowski**. Mr. Pease will inquire.

Mr. **Pease**. Thank you very much, Mr. Chairman, and thank you very much for your testimony, Mr. Secretary.

As I have listened to you this morning and your testimony, and in your response to other questions, you have laid a great deal of stress on easing the tax burden on equity financing. You have called several times for leveling the playing field between debt and equity and financing.

My question to you is, If Congress were to eliminate the double taxation of dividends altogether, do you think that would provide a level playing field in terms of the attractiveness of equity financing versus debt financing for the sort of takeover activity we have seen in recent years?

Secretary **Brady**. I feel if you did that, LBO activity would cease, largely.

Mr. **Pease**. In other words, you think apparently that the takeover activity could continue with equity financing? I am curious to know your reasoning. Would it not be necessary, if you were going to raise a great deal of money from equity offerings to go through the regulatory process for new issuances? What about the time that is involved, and what about the greater return for junk bonds versus the normal equity offering?

Secretary **Brady**. Well, I think that in the leveling process, Congressman Pease, what would happen is that the 34 percent that you pay to the Government would be available either through credits or otherwise to the shareholders. I think that dividends would go up, and people would use equity instead of debt.

Mr. **Pease**. Well, let's say that a major takeover artist—KKR, whatever—wants to take over another company. Can they do that? Would they be able to do that with the equity route?

Secretary **Brady**. Sure.

Mr. **Pease**. How about the time factor? Could they afford the time to put together a package like that?

Secretary **Brady**. A lot of these transactions actually take place on a basis where they are announced and the deal is concluded, and then there is a long period of time whereby the money is raised; it can take 2, 3, 4 months after the time that LBO deal is agreed to by a board of directors and potential acquirer to dot the "i's" and cross the "t's" of the transaction.

So, going through the SEC to a greater degree or lesser degree could be done very easily.

Mr. **Pease**. And you think the rate of return by equity financing could be somewhere near equally attractive given elimination of double taxation of dividends?

Secretary **Brady**. I think, say, if you level them, then you bring back into play equity, and I think that if we are looking for a solution to problems, that is where we ought to go.

Mr. **Pease**. I understand that is where you think we ought to go, but I am trying to figure out the reasonableness of any expectation that you would move the activity back to the equity side.

What leads you to believe that if there were an elimination of double taxation altogether that equity would become equally attractive as a means of raising the money for this activity?

Secretary **Brady**. What leads me to that belief is the fact that when an LBO person who is putting an LBO together, can take the 34 percent that used to go to the Federal Government in taxes, and add it to the payout to the new security holders—and I look at them as security holders as opposed to debt or equity holders—when he can do that, and the guy who is trying to maintain a corporation based on equity has to pay the Government for earnings before they can be paid out as dividends, it is almost arithmetically certain that the person who doesn't have to pay the government 34 percent is going to be able to produce a higher value.

So, if you level the scales, then I think—I am absolutely convinced—that you would swing back to equity again.

Mr. **Pease**. OK. Let me ask you one other question, then. In your statement, in the conclusion, you state you want to issue a challenge to those who make the financing decisions and the financial institutions which advise them, and that challenge is to look at the evidence and give us new proposals for solutions.

You say, "It is in the finest tradition of our democratic system that the government look first to the people themselves for solutions and act only when it is clear that the people want it."

Are you equating all these Wall Street high rollers with the people?

Secretary **Brady**. I will leave that up to you, sir.

Mr. **Pease**. I think Mr. Dorgan especially would be interested in the answer to that. I have a little trouble with going to the high rollers on Wall Street and saying, "Gee, we are not sure we can find a solution to this problem, why don't you find a solution to it?" Are you comfortable with that?

Secretary **Brady**. Well, yes, I am. I think that they have an obligation to do as I said we would do: spend as much time thinking about where we ought to go as they have in taking us there.

They certainly know the most about the problem. If this is a trend that we should be worried about, and I said it is, I would like to ask the people that understand most about it, what do you think? But——

Mr. **Pease**. I suppose they would think that it is a fine idea that they could make all this money, wouldn't they?

Secretary **Brady**. Well, I don't know.

Mr. **Pease**. I am questioning how realistic you are in expecting the industry that is profiting so greatly from these takeovers to examine the problem and come up with solutions that presumably would reduce their ability to make all this money.

Secretary **Brady**. Well, I think the fact that you are making that statement ought to make them more readily exercised to do so. I believe that they can do it, and I believe they can look beyond their own pocketbooks, and they should.

Many of them are young, and they ought to think of a profession instead of a job of 3 or 4 or 5 years to beat the system and move on.

Mr. **Pease**. Thank you, Mr. Secretary. I never realized my utterances had that much influence, but we will see if they do.

Chairman **Rostenkowski**. Mr. Thomas will inquire.

Mr. **Thomas**. Thank you, Mr. Chairman.

Thank you very much, Mr. Secretary, for your testimony. I know that as the tax-writing committee, we are going to be sitting here, and we are looking for silver bullets, and listening to my colleague, it is appropriate given the jurisdiction of the committee.

But one of my fears was alleviated by your testimony. I hope we can go back and examine the specifics of your testimony, that to me what has occurred is more of a warning signal. The problem is far more complex. We ought not to just focus on taxing interest or trying to deal with double taxation of dividends, but that what we ought to be doing instead of looking at tactical is looking at the strategic.

I hope you stick to your position as outlined in your testimony that what we have got to do is look at the question of corporations in today's world, with the increasing financial ability of the Japanese and their willingness to involve themselves in the market, with the Europeans driving toward a single market by 1992 and the corporate restructuring going on there.

It is all well and good for us to say who is winning inside the United States and how we should alter the equation, but I think this launches from the Treasury Department and from this committee and other committees as well a reevaluation of the whole question of corporate taxation and where we are going in terms of allowing these entities to be successful within the world competition. Yes, we may be able to come up with a very small fix in this area, but to me, it is a far more useful exercise to see it as a warning signal that we will have to continue to reevaluate the way corporations are taxed and whether or not we have a built-in handicap in competition around the world. I want to underscore your point in which you say that the definees are far better at playing the game than the definers. I firmly believe that.

We can lead from one change in the Tax Code to another change, trying to chase down what we perceive as problems and missing the whole fundamental point. The purpose is to raise revenue, but not to the extent that it makes us noncompetitive in the world, and I would appreciate a reaction.

Secretary **Brady**. You stated it more eloquently than I have. We have to keep our eye on that, making sure that our U.S. corporations can compete against the corporations that we have to compete with around the world, the Japanese and the Germans, the English, French and Italians, and not only should we look at how this competition affects us with regard to the tax laws, we have to be careful we don't do something in that regard that puts our corporations at a disadvantage with foreigners.

Mr. **Thomas**. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Dorgan?

Mr. **Dorgan**. Thank you, Mr. Chairman.

Mr. Secretary, you and I have different feelings about what all of this means. There is certainly room for differences. We see wild speculation in our economy and particularly in Wall Street. There is an orgy of greed fueled by a mountain of debt that persuades me it is unhealthy for our economy.

If I hear you correctly, you say there is no major problem here at this point. That reminds me a bit of the message that General Custer's scouts gave him as he went through North Dakota, on the way to Little Big Horn.

I think there are major problems developing. It seems to me that all of us, the Treasury, the administration and those of us in the Congress, want the same thing for the economy. I was interested in the questions Mr. Pease asked you. He asked you if you even the playing field between equity and debt, would that resolve most of these issues? Would we still see the same kind of activity? And you said no.

What about the hostile takeovers in our economy that represent a minnow fueled by junk bonds chasing a whale. You know what I am talking about? People who become players because someone gives them $1 billion of credit and they go after companies which, for the most part, have been at average performance or above. They try to find the undervalued assets and then they go after them with junk bonds. How would that activity be abated if we dealt with the equity/debt question?

Secretary **Brady**. The equity wouldn't be undervalued at that time.

Mr. **Dorgan**. Are you saying that the market makes a determination that will not allow the Icahns and others to find undervalued assets on the marketplace?

Secretary **Brady**. They wouldn't be selling on an undervalued basis. If you take the typical corporation that is capitalized by equity, a good, a conservative debt-equity ratio, as the income stream comes down from sales to pre-tax income, they pay the government 34 percent, then this, the net income after taxes is paid out in dividends.

So if you gave them the same break of not paying corporate income or level the playing field, the value of debt compared to equity would change, and the assets wouldn't be undervalued.

Mr. **Dorgan**. But they are undervalued due to the financial structure. What about two companies that you and I each run with identical assets and products. You are across the street from me. You are a Donald Trump type. You are all over the media with press conferences. You are soaking those assets for every dollar that you can get.

I, on the other hand, am doing research and developing investments, building the foundation for the long term, doing a good job. Would I be the potential target for a hostile takeover, in your judgment?

Secretary **Brady**. I think in today's world, since the great portion of the securities markets think short term, at the instant in time that you are probably talking about your company would be the greater target. However, as time goes on, if my company is doing foolish things, holding press conferences and flopping a lot of fluff around, eventually I will get caught at it, because my profits are going down; you are paying attention and I am not.

Mr. **Dorgan**. My company would be a target, not due to its capital structure, but due with the way I am running my company and the intrinsic value that the investors place on the stocks at that time. That is the point I am trying to make. I think the answer to Mr. Pease's question is even if we level the playing field, you are still going to have relatively unabated kinds of activity.

Secretary **Brady**. Sir, I disagree with you. That assumes that investors are stupid and they don't know that I am doing the wrong thing and you the right. I am not willing to go that far. I think the shrewd investors in this world know exactly—in the example that you laid out, that you are doing the right thing.

They buy your stock and not mine. They won't sell just because some guy comes along.

Mr. **Dorgan**. I have trouble believing that we have the kind of shrewdness in the market when we have 100 points on the up side one day and the reverse the next day. I am not sure that that is all the product of shrewd evaluation of asset values.

Secretary **Brady**. I don't think the wild speculation is the product of shrewd evaluation of assets. I mean we have other parts in the system which the task force, which I headed, specifically referred to and those recommendations stand on their own foundation.

Mr. **Dorgan**. Let me ask about junk bonds, if I might. The issuance of junk bonds has increased geometrically in recent years. If we have an economic downturn, some modeling suggests that we could face very difficult periods. What is your analysis?

Is Treasury prepared to step in and bail out some big corporations if necessary? Is this a no-fault capitalization or are the people out there at risk who issue the junk bonds?

If we have a downturn is it tough luck? What is your analysis of what you might do and what you might recommend and how much danger this poses in the event of an economic downturn?

Secretary **Brady**. I said this trend has arisen at a time when we have had 72 months of expansion. My question to you is whether people who are putting together these LBO's have thought through what might happen in a recession. I am certainly not predicting a recession.

I think that things look OK. But I can't speculate about what the Treasury would do or what the Congress would do. Sometimes they let them go down. Other times they save them.

Mr. **Dorgan**. We will have a downturn—but if I might ask just one final question, Mr. Chairman, briefly. Mr. Secretary, you and I agree that in the longer term our success is to have American companies build better products and sell them at better prices.

Peter Drucker has done some writing on this question of hostile takeovers and raiders and what it has done to American corporations and their performance. I was going to read it to you, but I won't. But he says it has caused them to turn inward and not necessarily do what is best for the long term, but do what is important to protect themselves for the short term.

I submit that is not good for this country's long-term ability to compete. My guess is that you would agree with that?

Secretary **Brady**. I do.

Chairman **Rostenkowski**. The time of the gentleman has expired. Mr. Levin?

Mr. Andrews?

Mr. **Andrews**. Thank you, Mr. Chairman. Thank you for coming today, Mr. Secretary. I think you really have phrased for us the broadest issue that we face and that is how are we going to make ourselves more competitive in the next decade and generation and what we need to be doing as a Congress and as an administration to assure through the Tax Code, at least this committee's jurisdiction, that we can accomplish those goals.

But I must say, like my colleague, Mr. Frenzel, that I have never seen an issue where the Congress is more perplexed and concerned than this one. And where we as a group are looking to the administration and to you for specific recommendations of tax policies and public policies that we should undertake, and you suggested we may look back at this hearing as an academic discussion.

I think that is about all we have had together. I think it has been useful, but I must say that I hope as we proceed in this discussion and proceed with these issues, that we will get very specific leadership suggestions from you and from the administration on what sort of action we should take.

It is one thing to be troubled by LBO's. I think all of us are, quite frankly. It is one thing to be perplexed, but the harder tasks of decisionmaking, that is the tough part. If you would just sort of recap for us, assuming that LBO's probably continue in a manner that you view as troublesome, a problem continues to grow. What specific suggestions would you have for the committee that we should be considering?

Would you enumerate for us what specific things you think the Congress should be reviewing?

Secretary **Brady**. Congressman, if the trend should continue and you know, as I mentioned, earlier, I am not sure it is going to, I am not sure that we have leveled off. But if it does continue, I think I have been very specific, which is to say that I think the problem is very directly the difference with which we treat equity as compared to debt.

And if this trend continues, I think the thing we ought to face up to in this country is that we have given a very definite advantage to the use of debt as compared to the use of common stock and equity.

And we ought to, if the trend continues, try to do something about that by increasing the value of equity by leveling the playing field. I think that is pretty specific, frankly.

Mr. **Andrews**. What would be the next step in doing that? Would you enumerate the specific things we should do?

Secretary **Brady**. I think the thing that we ought to do, if the trend continues, is to try to reach some understanding of how we might be able to allow less of a tax deduction for interest and less tax penalty on dividends.

I think by the same token, we are ducking the issue here. It is that we have a free market in this country and what it has done is found its way quite clearly around the double taxation of dividends. It is very, very clear. So I think we ought to face that and not duck around in asking ourselves whether it is something that comes from some other course.

I am asserting, which I think is pretty specific, that the opinion of the Treasury, in my opinion, is that it comes from the particular way we do business and if you agree with me, then I think where we ought to look is at trying to stop the difference in the way we treat debt, because of the way we treat interest, and the way we treat equity.

I think that is pretty specific.

Mr. ANDREWS. Let me ask you about capital gains taxes. What kind of impact do you think that 1986 Reform Act has had on decisions to substitute debt for equity in the marketplace?

Secretary BRADY. I am sorry.

Mr. ANDREWS. Relative to the capital gains tax, what kind of impact do you think increasing the tax in the 1986 act has had on corporate decisions to substitute debt for equity?

Secretary BRADY. Well, I am not sure that there is any discernable difference. I think what it did, it was all part of one package and I supported the final package. What it does is makes no distinction between the way capital gains are treated and ordinary income.

So perhaps in that case people don't really try to invest for the long term as much as they should.

Chairman ROSTENKOWSKI. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Secretary, last week Chairman Greenspan indicated that if there is a downturn in the economy as many as 40 percent of the takeovers that have taken place could be a cause of concern. What kind of concerns do you have about that prospect?

Secretary BRADY. Well, pretty much the same one, Mr. Coyne, that this trend has taken place during a time that we have had, running on 74 months now, of economic expansion.

That can lead one to think that we can count on that forever. Now, I am not predicting a downturn. What I see of the economy now, it looks darned good. But you know, it is not always going to be the same. And capitalizing a corporation where you have 80 or 90 percent debt does the same thing to a corporation that it does to an individual.

It decreases the margin by which you can handle unpleasant incidents. I think that is not a great way to live.

Mr. COYNE. Well, I represent a district in Pittsburgh that had two large corporations, significant employers that were the subject of takeovers; that is, the Chevron takeover of Gulf and the Beazer takeover of the Coppers Corp.

We do have significant concerns about the employment effects relative to these takeovers, Mr. Chairman. I would like to ask unanimous consent to revise and extend my remarks and to insert into the record a statement.

Chairman ROSTENKOWSKI. Without objection, so ordered.

[The statement of Mr. Coyne follows:]

TESTIMONY OF CONGRESSMAN WILLIAM J. COYNE

Hearings on Leveraged Buyouts
Committee on Ways and Means
January 31, 1989

I want to commend you, Mr. Chairman, for holding these hearings on leveraged buyouts.

Concern over the impact of mergers and acquisitions in the United States is not new to Congress. The 1982 Tax Equity and Fiscal Responsibility Act contained provisions related to the treatment of asset distributions and stock purchases in mergers. The 1984 Deficit Reduction Act changed the provisions of the Tax Code relating to debt-financed purchases of stock and "golden parachute" payments. In 1985, the Subcommittees on Oversight and Select Revenue Measures of this Committee conducted hearings on tax aspects of mergers and acquisitions. In 1986, the Tax Reform Act disallowed deductions for greenmail and standstill payments and well as repealing the General Utilities rule regarding the distribution of property. The House version of the 1987 reconciliation bill would have limited the deduction of interest on acquisition-related debt, would have placed a 50% excise tax on greenmail, and would have created "tax disincentives" to discourage hostile takeovers.

Over the past four years, Congress has tended to focus attention on the problems caused for corporations by hostile takeovers. In general, if a takeover was not opposed by the acquired company, it was not likely to command the attention of Congress, the administration, Wall Street and the news media.

That situation is changing now that the corporate sector has begun to expand the use of leveraged funds to finance takeover activity.

A leveraged buy-out -- LBO -- is an acquisition in which most of the purchase price is borrowed, using the firm's assets as collateral. The debt is used to buy back outstanding stock, a process known as "going private". Activity in LBOs has increased significantly and quickly during the 1980s. Between 1982 and 1988, American non-financial companies nearly doubled their debt, to $1.8 trillion, and retired more than $400 billion in equity. According to the Federal Reserve, the interest payments on the total corporate debt in 1988 are equal to 20% of corporations' available cash -- "a level usually reached only during recessions". At present, LBOs account for more than $300 billion of corporate debt, including $150 billion in bank loans and a similar amount in "junk" bonds -- high-yield corporate bonds which are unrated or rated below "investment grade" by Moody's or Standard and Poor's. Most of this acquisition lending has occurred during the past two years. Borrowing for buy-outs increased to $90.9 billion in 1988, from $30 billion in 1987 and $16.2 billion in 1984.

It has been suggested by numerous parties -- including Paul Volcker, Preston Martin, Alan Greenspan and Beryl Sprinkel -- that provisions of the Tax Code, in its present form, have contributed to the widespread substitution of debt for equity among major U.S. corporations. Every discussion of LBOs that has appeared recently in the news media attributes the increase in LBO activity to the deductibility of interest on corporate debt.

Takeovers are not new, but the increase in acquisitions financed primarily by debt is. Such acquisitions exhibit all the problems we have previously identified as accompanying takeovers. But, debt-financed buyouts have the potential to cause more widespread damage than an acquisition financed by other means.

Firms that have substantially increased their debt load because of an involvement in a merger or acquisition could experience serious problems in the event of a recession. It is obvious that such problems would have a negative impact on the managers and stockholders of the troubled firm. However, the potential negative impact of takeovers extends beyond those experienced by owners of the firms. The default or bankruptcy of a heavily-indebted firm can affect the financial industry, the private pension system, firm employees and the communities in which those firms are located.

The single biggest problem associated with the present LBO movement is the potential for bankruptcy and default in the event of a recession. When the economy slows down, demand for goods and services declines. This, in turn, depresses sales and cash flow and can leave a heavily indebted firm unable to meet its debt-service obligations. In 1988, Revco D.S. -- a Cleveland-based firm that went private less than two years ago in an LBO deal -- declared bankruptcy when its cash flow, of about $125 million per year, was insufficient to meet its annual interest payments of $150 million.

A recession is also likely to depress the market value of assets of these firms, thereby making it harder for the indebted firm to retire debt with the proceeds from asset sales. The Campeau Corporation received $550 million less than expected for the sales of stores associated with Federated Department Stores and Allied Stores, divisions acquired in buyouts in 1988 and 1986. Recent reports in the Wall Street Journal suggest that the Campeau enterprise may be forced to sell even more of its assets to meet debt obligations if the stores' sales don't improve significantly. The Campeau Corporation's current total debt is $9.9 billion.

If real or nominal interest rates increase, debt-service obligations for indebted firms will likewise increase. While recessions have a negative impact on all firms, those firms that are financed through equity have the ability to reduce or cancel stock dividends if corporate earnings slump. It is far less likely that the management of a heavily indebted firm will be able to persuade creditors to accept lower interest and principal payments. Thus, the appearance of recession conditions can force an indebted firm to default on loan payments or, ultimately, file for bankruptcy. According to Business Week, in 1984, 51 large companies defaulted in $11 billion in debt. In 1987, 87 companies defaulted in $21.4 billion, almost twice as much as three years earlier.

If interest rates increase during a recession, debt service may exceed the cash resources of the corporations, forcing them to default on their loans, to close or sell off plants, or to file for bankruptcy. According to a recently released study written by Professors Bernanke and Campbell of Princeton University, a recession of the magnitude of that occurring in 1973-74 could cause the debt of up to 10% of major U.S. corporations to exceed their assets, forcing those firms into bankruptcy.

The financing of LBOs increases the potential for instability in the financial industry if a recession forces a number of firms to default on their loans or declare bankruptcy. The involvement of banks in recent LBOs has been compared to the problems of bank loans to less-developed countries (LDCs). Both involve large volume loans with high-risk, high-yield terms. An important difference between the two is that none but the largest banks has been significantly involved in loans to LDCs, while small financial institutions -- including regional banks and thrift institutions -- have purchased "shares" in large bank LBO deals. Smaller banks are less likely to be able to absorb the cost of a defaulted LBO loan. The ten banks most active in LBO financing have originated a total of $80 billion in senior debt for buy-outs. However, their current portfolios include less than $20 billion in LBO loans. According to the Washington Post, "...[B]anks that originate LBO loans are holding only about 10 percent to 25 percent of them... The banks sell 40 percent to 50 percent to foreign banks, about 10 percent to 15 percent to smaller banks and savings and loans, and the rest to pension funds and insurance companies." The ten most active banks also hold approximately $55 billion in loans to LDCs, bringing their holdings of high-risk loans to more than $75 billion.

Since the Federal government guarantees the deposits of many banks and S&Ls, instability in these sectors could lead to a heavy drain on the fiscal resources of the federal government if these financial institutions are unable to bear the cost of LBO defaults or bankruptcies. According to the Federal Home Loan Bank Board, 434 thrifts, representing 14% of the total number of thrifts protected by FSLIC, were insolvent as of the end of September, 1988. According to a recent GAO study, it will cost approximately $85 billion to bail out the S & L industry and to return the FSLIC to solvency. The Federal Home Loan Bank Board sold or closed 217 savings institutions in 1988, compared with 48 in 1987. A small number of defaults by LBO-financed firms could quickly exacerbate the problems of this industry.

Likewise, recession-induced LBO bankruptcies could deplete the resources of the Pension Benefit Guaranty Corporation (PBGC) if the firms are unable to meet their employer contribution obligations. Pension funds invest substantial amounts of their assets in bonds. About 19% of the assets of private pensions were invested in bonds in 1987, while over 50% of the assets of state and local government pension systems were held as bonds.

The PBGC's single-employer pension plan termination insurance program already has a deficit of over $4 billion. Most of the deficit is due to the termination of several large underfunded plans of employers in the steel industry. However, Pensions & Investment Age estimated that the PBGC lost about $146 million during the first 26 days of October, when the stock market lost 22.6 percent of its value in the Black Monday crash. The stock market downturn has increased the PBGC's exposure in underfunded plans that may eventually terminate. If a recession develops, it is likely that additional firms would fail, raising the possibility that the PBGC would become involved in rescuing even more insufficiently funded plans. Given the extensive involvement of pension plans in LBOs, a recession which led to bankruptcies or defaults by LBO firms would erode the value of the plans, simultaneously increasing the costs to PBGC of guaranteeing the benefits for terminated firms and reducing the benefits to current and future retirees.

According to an article that appeared recently in Wall Street Journal, the IRS turned down the request of Eastern Airlines for a five-year waiver of payments to its employee pension fund. The request for a deferment of pension plan payments was one of a number of cost-reduction measures Eastern has taken. The airline has sold planes and laid-off thousands of employees in an attempt to reduce costs. Eastern Airlines has had losses of over a quarter of a billion dollars over the past two years and is experiencing serious cash flow problems. The Texas Air Corporation, of which Eastern Airlines is a unit, has been heavily involved in mergers and acquisitions in the past.

I am further concerned about the impact of LBOs on employees of the acquired corporation and on communities in which the acquired corporation is located. As you may recall, when Chevron acquired the Gulf Corporation in 1984, the corporate headquarters of Gulf, located in Pittsburgh, were closed. Almost two thousand Pittsburghers lost their jobs as a result of this decision. The economic consequences of the closing of Gulf headquarters extended beyond the impact on workers. The city of Pittsburgh lost $300,000 to $500,000 in local wage taxes contributed by those Gulf employees. Pittsburgh charities and non-profit organizations lost over $6 million in contributions from Gulf.

Goodyear Tire and Rubber Company went private in 1986 in defense against a takeover by James Goldsmith. In doing so, it borrowed $2.6 billion to buy back stock. According to Robert E. Mercer, Goodyear's chairman, construction of new tire factories that would assist Goodyear to compete in the world tire market has been delayed because corporate funds have had to be diverted to repay the debt. Over 1,500 jobs were eliminated at corporate headquarters and in various Goodyear divisions in an effort to reduce costs to meet debt service.

The Chrysler Corporation acquired AMC Motors in March of 1987. A year later, Chrysler announced the closing of the AMC plan in Kenosha, Wisconsin, and the layoff of over 5,000 workers.

According to one private study, fourteen hostile takeover contests occurring between 1985 and 1987 culminated in identifiable job losses totalling 118,500.

This past March, another Pittsburgh company, Koppers Inc., was the object of a hostile takeover. The successful bidders were part of a partnership consisting of Beazer PLC, American Express/Shearson Lehman, and the National Westminster Bank of England. The partnership announced its intention to finance the acquisition in part by selling off the chemical division of Koppers. During the time in which the acquisition was being negotiated, Koppers employees were subjected to uncertainty about their future if the takeover went through. Pennsylvania state officials estimated that up to 1,100 Koppers employees could have been laid off if the acquisition were successful.

In April of 1988, the Campeau Corporation acquired Federated Department Stores for $6.6 billion. Less than two months later, Campeau eliminated over 6,000 positions at Federated in an effort to reduce costs. A former manager of one of the Federated Stores told the Wall Street Journal, "They suddenly discovered the cuts they made went too deep and now they're in the Christmas selling season without experienced people."

More recently, the much-publicized leveraged buy-out of RJR Nabisco has produced the same level of uncertainty and fear for the employees of R. J. Reynolds and the town of Winston-Salem, North Carolina. According to an article appearing in the Wall Street Journal on November 30, many employees are concerned that RJR will be forced to lay off employees in order to meet debt service requirements. Other residents expect that RJR will no longer be able to provide financial assistance to the libraries, hospitals, schools and playgrounds of Winston-Salem. The impact of RJR Nabisco's restructuring is particularly distressing in light of the fact that the chief executive officer of RJR Nabisco moved the firm's corporate headquarters from Winston-Salem to Atlanta, Georgia, just last year, following the merger of the two firms, laying off 600 corporate employees in the process.

Just last month, Prime Computer Inc. of Massachusetts announced it would lay off 1,200 people -- approximately 10% of its workforce. The layoffs are necessary to cut costs related to Prime's recent acquisition of Computervision. Prime previously cut 700 jobs after acquiring Computervision, bringing the total number of jobs lost because of this acquisition to 1,900.

I am concerned that the tax code is encouraging mergers, acquisitions and buy-outs that may have a significant, adverse impact on employees and communities. During the hearings on mergers and acquisitions held by the Oversight and Select Revenue Measures Subcommittees in 1985, I testified that the Ways and Means Committee must be ready to look beyond whether an acquisition is harmful to any particular industry. We must determine what effect mergers and acquisitions have on employment and communities.

In 1984, in response to the problems caused by the closing of Gulf's headquarters, I introduced the Corporate Community Investment and Jobs Preservation Act. I have recently reintroduced this legislation, which is now H.R. ~~xxxx~~ 679. This bill would deny the interest deduction for debt acquired to finance an acquisition that is determined not to be in the public interest -- specifically those that result in a significant loss of jobs. I believe that it does not make sense to provide tax subsidies for corporate acquisitions that are found to be not in the public interest. H.R. xxxx 679 supports the idea that, in such circumstances, sound tax policy should not work to benefit corporations at the expense of employees and communities. The federal government, through the tax code, should have no role in the indirect financing of an acquisition which eliminates jobs or dismantles communities.

Those who defend corporate takeovers often list a number of benefits to be gained from "corporate reorganizations". Among the benefits realized are the profits obtained by target-company shareholders, the increased awareness of corporate management of the need to perform well or be replaced, the efficiency to be achieved through economies of scale emerging from the combination of the companies' administrative and managerial staffs, and the healthy rationalization of capital structure associated with the substitution of debt for corporate capital.

As this Committee evaluates the costs and benefits of altering tax policy in response to the increase in corporate takeover activity and the growth of corporate debt, it is important to weigh the theoretical economic gains we might experience from continuing takeovers -- activity we are encouraging by providing interest deductibility as a corporate tax benefit -- against the real costs imposed on workers, Chairman ROSTENKOWSKI. Mr. Brown will inquire.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. Secretary, you testified that there are offsetting budgetary impacts here, the capital gains revenue that can come about and noting the potential drop in revenue when you replace equity with interest or with debt instruments that pay interest.

I was interested in that analysis. What happens when $100 million, let's say, is taken from a corporation's books, paid out? What happens to that $100 million? Doesn't it earn money? Isn't there a net addition of revenue to the Treasury of the earnings of the equity that is taken out of a corporation?

Secretary BRADY. Yes, sir.

I mean, the net effect our studies show us it is about level. The amount that has been lost on interest deduction has so far been added to by the fact that people pay taxes on the sale of their equity.

Mr. BROWN. I am sorry, that wasn't what I was trying to focus on. I understand there is a potential for increased revenue by having to recognize the gain on the investment.

But my point is a different one. I understand how you could assume that removing equity from a corporation's books would reduce the amount of taxable income that corporation might pay. My question is, isn't there an offset because the equity that is removed from that corporation's books is invested somewhere and earns something?

In other words, haven't we missed a major revenue source and that is the reinvestment of that equity that has been removed from the corporate books?

Secretary BRADY. That is correct.

Mr. BROWN. In other words, well, depending on differential rates of return, if there is no major difference in differential rates, no big difference in rates of return where it is invested, there is no loss to the Treasury whatsoever on the adjustment of equity in a corporation?

Secretary BRADY. Well, so far that is what our studies show.

Mr. BROWN. I wanted to make that point because if you assume that there is a gain, then on the disposition, on the capital gains or the disposition of assets, what you are looking at here is a net gain on revenue to the Treasury by this activity, not a loss, wouldn't that be the case?

Secretary BRADY. Well, I am not sure that you can come to that conclusion, sir. Our revenue estimates assume, and maybe you should, no increase in total economic activity and perhaps that is what you are referring to.

Mr. BROWN. What I was concerned about is I heard you recite the figures. You have not taken into account the fact that the equity moved from a corporation is invested somewhere else and continues to generate taxable income.

My concern was that you had only taken a look at part of the picture in doing your budget analysis.

Secretary BRADY. That is right if the equity removed from the corporation was earning 10 percent and the new activity is 10 percent. Then it is a net wash.

Mr. BROWN. Thank you.

My second question is, if we allow for deductibility of dividends in some way, don't we discourage corporations from saving? My understanding is that right now corporate savings are a significant component of our net savings as a nation.

If we allow the deductibility of dividends and thereby increase dividend payments out of corporations, isn't it possible that we will have a negative impact on capital formation in this Nation?

Secretary BRADY. Mr. Congressman, I don't think so, because what you would do in that case is instead of people doing it through receiving interest, it would be through receiving dividends. It ought to be about the same because this activity goes down and this one goes up.

Mr. BROWN. In other words, you are saying that you don't think the propensity of a corporation to save is significantly different than the individuals who may receive that money? Or you are saying that there is no net difference depending on interest or dividends?

Secretary BRADY. Yes.

Mr. BROWN. I see. This is an unusual period in America's history in that we have a higher tax on corporate income than we do on personal income. Obviously that is quite a reversal from most of our history. What is the impact of adjusting that, of reducing the corporate tax rate slightly and increasing the personal rate slightly, but going to a system where you have higher rates for personal rather than corporate income?

Would that reduce the desirability of reducing equity in corporations?

Secretary BRADY. I think you would get more of your savings from a national point of view in corporations and less in individuals.

Chairman ROSTENKOWSKI. The time of the gentleman has expired.

Mr. Rangel will inquire.

Mr. RANGEL. Thank you, Mr. Chairman, and welcome, Mr. Secretary. I would like to pursue the line of questioning that Mr. Brown was sharing with you. Some 8 years ago we thought that the President was saying that if we dramatically reduced the tax rates that this would lead corporations and, indeed, individuals toward more savings and through the savings would create capital formation.

And through this there would be larger investments in plant and equipment and as a result of this, we would find expansion, increased productivity and our Nation would become so competitive that there would be sharp increases in revenues and therefore increases in taxes and in the long run, there would be no loss in revenues.

If we believed that policy—and I didn't at that time—would not your support of a discriminatory tax system that clearly encourages debt, where corporations are not driven by what will create more jobs and more products, but more or less driven now by what you claim to be an unequal playing field—does this not fly in the face of the initial tax decrease that the administration led and encouraged and indicated that it was revenue-raising, not just tax rate reduction?

Secretary BRADY. Well, maybe I don't understand the question.

Chairman Rostenkowski. I don't either.

Mr. Rangel. In small parts, do you believe that these mergers and acquisitions are driven by the Tax Code considerations, rather than plant expansion considerations?

Secretary Brady. I think that the LBO activity is driven by tax considerations.

Mr. Rangel. Do you believe that it encourages the use of debt rather than encouraging savings?

Secretary Brady. I can't make the distinction between debt and savings.

Mr. Rangel. Well, equity, do you believe it favors debt rather than equity?

Secretary Brady. Yes, I do.

Mr. Rangel. Do you believe that the dramatic reduction in the tax rates was supposed to encourage equity rather than debt?

Secretary Brady. I don't know that we could reach that conclusion. It was hoped that it might increase savings. The saver has the choice of common stocks or dividends or debt and interest. So I can't make that distinction.

Mr. Rangel. Then you don't believe that the Economic Recovery Tax Act was supposed to encourage equity savings? That that act could have just as easily lent itself to the use of acquiring more debt?

Secretary Brady. I think it was aimed at increasing savings and the saver has the choice of either investing it in the common stock market or he could go buy a bond or a money market fund which in turn invests its money in Treasury bills and that kind of thing.

So I think that the saver is left free to decide for himself what form of savings he wants to engage in.

Mr. Rangel. Well, Mr. Secretary, what is your view as relates on our economy about the size of the deficit or the tendency of the last 8 years of our country to become a debtor nation as opposed to a creditor nation? Does that influence your neutrality on the question of how we treat the use of debt in the Tax Code?

Secretary Brady. Well, I don't know—I don't want to quarrel with words. I don't know if neutrality is the way I would describe what I have suggested, which is to make this change.

Mr. Rangel. I thought you had no position as to whether or not we should change the Tax Code and that you thought we should not make any changes at this time.

Secretary Brady. Well, my statement is that I think we do not know at this moment whether this trend is going straight up or whether it is leveling up or going down.

Mr. Rangel. You don't have a position in terms of directing us to do anything?

Secretary Brady. No, my feeling at this point in time is that the trend is not so discernible that we should do anything at this point. If the trend continues, I think I have been very specific, which I don't know as anybody else has. I am not talking about the panel here, but people have commented on this trend that if it continues then what we ought to try to do is level the playing field, reduce the tax—I mean the deduction on interest, give it offsetting——

Mr. Rangel. Do you have any feelings about the debt which our Nation has assumed during the last 8 years and the amount of interest that we are paying in our budget? Do you have any feelings as to whether or not, compared with the gross national product, is there a crisis in your opinion at all?

Secretary **Brady**. I think it is a problem that needs very heavy attention and which is getting very heavy attention. The question is where we are. The G–7 ministers will be over here this week, and we have discussions with them and will ask them about what the U.S. position is against the rest of the world in this matter.

The truth of the matter is that our deficit is too big. The President is committed to reach the Gramm-Rudman-Hollings target of $100 billion and I am convinced that he will do that. And our deficit as a percentage of GNP, has come down from 6.4 percent, I think it was in the middle eighties, to where it is now, slightly over 3 percent.

This does not compare unfavorably with a lot of other countries in the world. Most of the other countries in the world, if you add in the debt of their municipalities and States, you will find that we compare quite favorably with them. So the main thing is to reduce the deficit.

Chairman **Rostenkowski**. The time of the gentleman has expired.

Mrs. Kennelly.

Mrs. **Kennelly**. Thank you. Mr. Secretary, I couldn't agree with you more. We shouldn't pass new rules that will handicap our U.S. industries in relation to our competitors, but I would caution you about something, because I seem to hear a trend this morning.

I would caution you about believing that this growth in leverage buyouts can be handled just by leveling the field between debt and equity. I would also caution you about something else. We tried in 1986 to make corporations pay their fair share of taxes. You use that 34-percent rate figure, but I have to tell you an awful lot of companies are not paying that 34 percent. So you ought to be cautious about that.

I want to ask you about debt, Mr. Secretary. You said—I think at least twice, maybe more, that the definees are quicker than the definers. And I just wonder, do you base that feeling on the fact that you think our Tax Code has become so incredibly complicated that the definee can manipulate what the definer had intended or do you think that the debt is simply fungible?

Has your team advised you that it would be almost impossible for us, say, to put a lower interest deduction on leverage interest income, but easier to do something about increasing our capital investment?

I guess my final point is, is debt fungible or do we have such a complicated Tax Code that manipulation is inevitable?

Secretary **Brady**. Well, if I have got the question right, Mrs. Kennelly, I think that the problem is that the definition of debt merely lasts a short period of time before people get around it. The definees are quicker than the definers. We have had times at the Treasury where we put out rules which we thought were going to get the job done and we had to withdraw them because people simply went around them.

The point I would make is when you have a moving force—maybe glacial, maybe not glacial, certainly it is moving fast, but it has the force of a glacier—which is that the free market has found its way around the double taxation of dividends, you can't define that out of existence.

I don't think that we will be anymore successful than in the past once the market has found its way to get around us. By a combination of LBO's, arbitraguers and junk bonds, they have gotten around it.

I am not saying anything about these activities but you have to look at them all as one. The thing that started the arbitrage activity on its increase and really defined the increase in the junk bond market was that there was an incentive to try to get your way around the double taxation of dividends, I am convinced of that.

Mrs. **KENNELLY**. Let me just ask——

Secretary **BRADY**. Excuse me, if you define it a bit, that force being a big, vibrant force, you will never be able to define it out of existence, in my opinion.

Mrs. **KENNELLY**. Thank you. You have said time and time again this morning that if this trend continues, the possible answer would be to reduce the tax on dividends and lower the amount that you can deduct of interest income to try to level that playing field between debt and equity.

Let me ask you something. Would it be possible or do you think that it would be terribly detrimental if we just begin to reduce the amount of interest that can be deducted without touching the dividends?

Secretary **BRADY**. Well, that is one way to go at it. You wouldn't improve the values of common stocks by that approach and the risk involved is the reason why up front in the testimony we had a section on competitiveness. We better make sure when we do that we haven't given a big advantage to foreign corporations to do the acquiring.

Mrs. **KENNELLY**. Thank you.

Chairman **ROSTENKOWSKI**. The Chair is making an effort to give everybody an opportunity to question, Mr. Secretary. The Chair will also announce that we are going to work through lunch. We have many important witnesses that we have asked to testify before us today and I am going to try to accommodate everybody that has come here to Washington.

The Chair recognizes Mr. Flippo.

Mr. **FLIPPO**. Thank you, Mr. Chairman.

Mr. Secretary, thank you for being here with us today. Mr. Secretary in the Journal of Economic Perspectives, a research study took a look at cash distributions to shareholders. And their study indicated that the taxable income—it used to be 80 percent of the cash distribution to stockholders—was in the form of taxable dividends. That has now fallen to about 40 percent, where the nontaxable cash distribution was 20 percent, has now grown to 60 percent.

So, if the Secretary has any information that would indicate that these trends are not continuing, I would appreciate it if he would submit that to us for the record. If these trends are continuing, then we are having a lot more distributions that are not dividends and therefore, not taxable and that is something that, as Treasury Secretary, would concern you.

Let me oversimplify what I think our problem is here. We have two options in dealing with this. One obvious option is to limit the deductibility of interest. Another is to eliminate the double taxations. One of the strongest arguments against limiting the deductibility of interest is that our international competitors permit deductions of interest, the Japanese, Europeans and others. Other arguments involve—it would probably severely restrict small businesses' ability to grow because they don't have the same access to equity markets that others do and there are other reasons.

The main reason I believe that we do not eliminate the double taxation is that it is just too doggone expensive. I think that is probably the strongest argument. So neither eliminating interest nor eliminating the double taxation is a feasible route for us to take, perhaps we should examine other methods.

I don't think that the Secretary is an advocate for greenmail, certainly he is not. Shouldn't we be pursuing with great vigor efforts to define and prohibit greenmail? Shouldn't we be pursuing earlier notification to the individuals involved when certain stock positions are taken? And primarily, I would like to ask the Secretary, if I understand how these things are done, the margin requirements under—corporations are not under the same margin requirements as individuals are.

And I am wondering if the Secretary would support having the same margin requirements for corporations as they do for the individual. And wouldn't that remove all of these things that I am talking about, attempts to remove the rewards that these individuals are receiving?

Secretary **Brady**. Well, with regard to the margin requirements, you are going to have testimony from Chairman Greenspan, I think, this afternoon or tomorrow. I think since the margin rules come under the Fed, I would prefer to leave that to his comment.

In the earlier part of your remarks, I think that maybe we disagree on one part, which is that I think that what I am suggesting is that by taxing interest at its higher levels, you would generate revenue. That revenue would be shifted to some relief for dividends.

In effect, it would be revenue neutral so that you do have the option of doing that.

Mr. **Flippo**. Do you have any problems with us really going after green mail?

Secretary **Brady**. Not at all.

Mr. **Flippo**. Do you have any problems with more prior notification than is currently required?

Secretary **Brady**. I would have to review the notification rules. I know they have been expanded during the recent years.

They are under Rodino and a number of other laws now, significant prenotification.

Mr. **Flippo**. Could the Secretary furnish us that at some later date?

Secretary **Brady**. Be glad to.

[The information follows:]

Prior Notification Requirements for LBOs

The Federal securities laws contain various notice and timing requirements for tender offers, proxy solicitations, and acquisitions of five percent beneficial ownership. In addition, the Federal antitrust laws require prior notice of significant acquisitions.

Although the securities and antitrust laws do not require a specific waiting period for LBOs (other than in connection with tender offers, etc.), legislation was proposed in the 100th Congress to require a minimum waiting period following the date a management LBO or going private transaction is publicly announced.

1. Tender Offers

Most leveraged buyouts are structured either as a tender offer, a merger, or (as in the case of RJR Nabisco) a tender offer followed by a merger in a two-step transaction.

If the transaction involves a tender offer, rule 14e-1 under the Securities Exchange Act of 1934 generally requires the bidder to keep the offer open for 20 business days. The Securities and Exchange Commission (SEC) can extend this minimum waiting period for various reasons. In practice, most tender offers are held open longer than 20 business days.

Several bills were introduced in the 100th Congress to extend the minimum offering period, for example to 30 business days (H.R. 2668), 35 business days (S. 1323), and 60 calendar days (H.R. 2172). Proponents believed that longer time periods would help target company shareholders make an informed investment decision, permit target boards of directors to evaluate offers more fully, and increase the premiums paid to shareholders.

Although the Administration has not yet reviewed this issue, I am inclined to believe the current 20-business-day period is sufficient. The present minimum offering period provides approximately a calendar month within which a target can mount a defense and investors can make an informed decision. Extending this period probably would increase the cost of tender offers, thereby reducing the benefits generated by the takeover process.

2. Waiting Period for Management LBOs and Going Private Transactions

At least two bills were introduced in the 100th Congress that would have prescribed additional requirements for certain LBOs. S. 1324 and S. 634 would have required that 60 days elapse between the day a proposed acquisition by the issuer's officers, directors or employees is publicly announced and the day the acquisition occurs. Both bills also would have required the issuer to obtain a fairness report by an independent appraiser.

For the reasons stated above, I am inclined not to support a waiting period for LBOs different from existing tender offer, proxy solicitation, and premerger notification requirements. In addition, the Commission's rule 13e-3 governing so-called "going private" transactions follows a full disclosure approach and leaves substantive fairness requirements to state law. In view of states' rights considerations I think the approach of rule 13e-3 is appropriate.

3. Proxy Solicitations

If the LBO involves a merger requiring proxy solicitations, section 14(a) of the Securities Exchange Act generally requires proxy solicitation materials to be on file with the Commission for 10 days before they are mailed to shareholders. In practice the SEC review process usually takes longer. State law also may require a proxy waiting period. We are not aware of any recent proposals to extend the 10-day filing period in connection with corporate takeovers and LBOs.

4. Five Percent Acquisitions

Section 13(d) of the Securities Exchange Act requires persons who acquire beneficial ownership of more than five percent of a class of covered equity securities to file a notice with the Commission, the exchanges and the issuer within 10 days after crossing the five percent threshold. This "10-day window" has in some instances enabled persons to acquire substantial positions prior to disclosure, thus depriving some shareholders of a control premium.

A number of proposals in the 100th Congress would have amended the requirements of section 13(d). Among them were proposals to impose a "standstill requirement" of two business days (H.R. 2172) and until filing (S. 1323), coupled with reductions in the 10-day window. Although reducing the 10-day window and imposing a standstill requirement may increase the costs of some takeovers and possibly deter some benefits of the corporate takeover process, I believe these ideas merit serious consideration in light of the speed with which shares can be acquired in today's market.

5. Hart-Scott-Rodino Requirements

The Hart Scott Rodino Antitrust Improvements Act of 1976 requires companies making acquisitions that meet certain thresholds to submit premerger notification information to the

Justice Department (DOJ) or Federal Trade Commission (FTC) for review of possible anticompetitive effects. The waiting period is 15 days for cash tender offers and 30 days for other acquisitions. These periods can be extended for various reasons, but in practice they often are shortened at the filer's request.

The reporting requirements only apply to transactions meeting each of two thresholds: (1) a "size of transaction" threshold of $15 million or 15 percent of the outstanding equity and (2) a "size of person" threshold of $10 million in sales or assets for one party and $100 million in sales or assets for the other.

In 1987 DOJ and FTC adopted a rule intended to close a so-called "partnership loophole" whereby the "size of person" test had looked only to the partnership's sales and assets rather than those of its owners. The rule now looks through the partnership to any 50 percent owner.

Recently, some partnerships (including some involved with LBOs) have been organized that did not have 50 percent owners or $10 million in sales or assets. DOJ and FTC are reviewing these transactions to determine whether additional changes in the law may be necessary.

The 100th Congress considered legislation to extend the Hart-Scott-Rodino waiting periods and increase the threshold requirements. S. 432, as amended and reported by the Senate Judiciary Committee, would have extended the waiting period for cash tender offers from 15 days to 20 for the first filing and from 10 days to 20 for subsequent filings. In addition, the bill would have authorized the courts to extend the waiting period for an additional 25 days in cases of especially complex filings. One of the bill's purposes was to make the timing of premerger notification more consistent with the SEC's minimum tender offer period and 13(d) reporting threshold. DOJ opposed the bill as originally proposed but later agreed to the compromise version adopted by the Committee that was incorporated into an interlocking directorate bill, S. 1068, that the Senate passed in 1987.

Chairman Rostenkowski. Mr. Shaw.

Mr. Shaw. Thank you, Mr. Chairman.

Mr. Secretary, double taxation of dividends is nothing new under the code. The deductibility of interest is nothing new under the code. But the leveraged buyouts to the extent that we are seeing it now, in the large corporate takeovers that we are seeing now, is relatively new to the economic scene. What do you attribute that to?

Secretary Brady. Well, Congressman, what I attribute it to is that there has been this—as you state quite clearly, the deductibility of interest has been in the code and the double taxation of dividends has been in the code.

People have talked about it, but nobody has ever been able to—somebody in the Government has never been able to do something about it.

There are a couple of sections in my testimony, which I didn't read this morning, which refer to this fact that since you have this difference in values out there, what has happened is you have created a junk bond market.

The increase in arbitrage activity is the means by which somebody, who wishes to recognize that difference in interest deductions and double taxation of dividends, gets the job done. It just took him a while to get there.

The junk bond market is something that is probably 6, 7 years old. Your arbitrage activity, there have always been arbitrageurs, but their involvement in this process is part of a train of events.

The fact that it didn't happen right away, as differences in the Tax Code existed, is because it took them a while to do it. This is what has happened.

We don't have the same thing in Germany, England or elsewhere. The reason is that they treat dividends more equitably with respect to debt.

There has been no reason in those countries for arbitrageurs to band together and link up with junk bonds to provide their own solution to this trend.

Mr. Shaw. This is not a problem, or this is not a phenomenon occurring in other countries? It is unique to the United States?

Secretary Brady. It may be starting elsewhere. But I don't think it will get very far because you don't have the basic engine out there, which is the difference in treatment of dividends as opposed to interest.

Mr. Shaw. Do you know what the loss of revenue and enhancement of revenue would be as to what is a tradeoff between the deduction of interest and——

Secretary Brady. The system that I was suggesting doesn't contemplate there to be any loss in revenues, although we haven't done——

Mr. Shaw. My question is have you done any projections as to what would be the impact on doing away with double taxation of dividends?

Secretary Brady. No, because the funding—well, I am not sure exactly where we stand on that study.

Fundamentally the change that we would suggest to make is to make no more of a change than you can balance out.

Mr. SHAW. You made that very clear and I understand that. I was wondering what the dollars were?

Secretary BRADY. I wouldn't suggest a change at a time when we have Gramm-Rudman on our backs.

Mr. SHAW. Part of the engine, as you refer to it, is the greed of some investors. Many of these investors, I am talking about the more dangerous types now that concern me more than anything else, their engine is greed.

I don't know a source of revenue where they can get into the market on the equity side. I think they have to go to the debt side.

I think you have got a whole class of investors out there that we have to take a look at, because I am very concerned about what is happening here with the debt being built and what is going to be the collapse of corporate America, should we have a serious recession, and then the refinancing of these corporations and the corporate structures will have to be sorted out by bankruptcy court rather than the people on Wall Street.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Jenkins.

Mr. JENKINS. Mr. Chairman, thank you.

Mr. Secretary, thank you for your appearance today. I know you are taking a somewhat cautious approach, and I agree with that.

Do you make any distinction in talking about LBO's between the deductibility of interest as it relates to an LBO and whether an acquisition is friendly or hostile?

Secretary BRADY. Well——

Mr. JENKINS. Whether friendly or unfriendly?

Secretary BRADY. You are talking about the difference between friendly and unfriendly?

Mr. JENKINS. Let us assume a corporation simply decides to buy another company, borrows money to make that purchase; would you make any distinction between the deductibility of interest for that purpose versus a hostile LBO?

Secretary BRADY. I think it would be awfully hard. Then you would be in the business of defining friendly and unfriendly. I just don't know how you do that.

Mr. JENKINS. If you limit interest deductions. Is the only way you see to do that to simply limit interest deductions, period.

Secretary BRADY. I wouldn't say "period." I think you have to have some relationship to the amount of debt involved and the amount of leverage involved.

In other words, I guess if you were going to do that—and I want to repeat that I would only suggest doing it if you took the savings from doing that and applied it to an increase in the deduction. I mean the increase in the value of money passed through to the shareholders as dividends.

If you did that, you would probably say about a certain percent of debt. You might get an interest deduction on the first 60 percent of debt.

You take the money that would ordinarily have gone there and apply it to the dividend side of the equation.

Mr. JENKINS. Let me present a situation with small figures for just a moment. Let me assume for a moment that one corporation is worth $10 million.

Corporation "B" is worth $10 million. Corporation "A" has $10 million in plant and equipment, no cash reserves. Corporation "B" has a sloppy operation, $2 million in plant and operations, $8 million in cash. Both corporations are interested in acquiring by debt another going concern. Would you end up favoring the one that simply has the cash reserves versus the one that has invested all of its funds in modern plant and equipment?

Secretary **BRADY**. If we changed the tax laws?

Mr. **JENKINS**. Yes.

Secretary **BRADY**. I assume you mean the guy that has the $10 million in plant has to borrow the money in order to make the acquisition and the other guy has it in his pocket?

Mr. **JENKINS**. Right.

Secretary **BRADY**. In that case, I think you would favor the guy that used his own money inside the corporation.

Mr. **JENKINS**. All right.

By the same token, would you make any distinction between borrowing operating funds as far as deductibility of interest?

Secretary **BRADY**. You know, you put your finger on the problem. We can come up with these definitions and say above a certain level you don't get any deduction for interest.

You probably—and when you have done that, unless you put the definition right, you penalize every startup in the country, every guy that wants to go to his bank and say, look, trust me. I would like to borrow the money. I don't have any.

But a guy that paid his debts, he might want to borrow 100 percent of a new enterprise. Here we have a definition that says if you have debt above 60 percent, you can't deduct it.

You have penalized the startup, the growing business which doesn't have the assets and earning power to advance its projects without borrowing, and you are back into the definition problem.

I think statistics will show you that the small growing businesses in this country are the people that are providing the jobs.

You know, my "short hopping" of saying the definees are quicker than the definers takes into account the fact that when you do that you have got to be sure you don't define out of existence the guys who are providing the increase in employment in this country.

Mr. **JENKINS**. If we are not careful in designing a system to attempt to get at LBO's, then we are going to penalize a lot of other corporations and their ability to grow?

Secretary **BRADY**. You have to be particularly careful about the small growing businesses who don't have the resources to put into it themselves who go to the bank and borrow the money and maybe put themselves up to their eyeballs in debt, but make a go of it and provide new jobs and come up with new products.

Mr. **JENKINS**. If we go with a cap on deductibility, 80 percent, and we used that other 20 percent to reduce the dividend portion——

Secretary **BRADY**. I think that is what we ought to do.

Mr. **JENKINS**. All right. Now let me ask you this.

Does that not increase the cost of capital for a lot of these small concerns that provide the jobs that want to expand legitimately?

Would you not want to have some threshold, some cap so that a company that wanted to borrow $1 million legitimately would not have to simply be limited to 80 percent of the interest costs?

Secretary **Brady**. Well, I think, you know, if the idea ever takes hold and you do want to go forward with this idea of defining interest above a certain debt level as nondeductible, you have to be very, very careful we don't stop every small businessman in this country from going to his local bank and trying to start something going.

Mr. **Jenkins**. We forced him into the equity market. He may not want to sell any stock.

Secretary **Brady**. There isn't necessarily an equity market for that small guy. His equity market is to go to the bank and put his character on the line.

Chairman **Rostenkowski**. Mr. Anthony.

Mr. **Anthony**. Thank you, Mr. Chairman.

Mr. Secretary, in our pamphlet that has been prepared by the Joint Tax Committee, ESOP's were mentioned.

As I understand it, they are used in 1 percent of the leveraged buyouts, corporate takeovers or in some cases utilized by management to try to prohibit potential hostile takeovers.

I just wondered what your position as Secretary of Treasury is on the utilization of ESOP's as a tool to do those things?

Secretary **Brady**. Congressman Anthony, I know this has been a matter of concern to you. My feeling is that if we can really be sure that the ESOP transfers ownership to the employees, that is a good thing.

If it is a device to stop takeovers and the employees are only a weigh station, a bus stop on the way to stopping that takeover, then it is probably not a good idea.

Mr. **Anthony**. If we, in fact, can make owners and equity holders out of employees, and do it in a proper way, you would be supportive of that?

Secretary **Brady**. I think it is a terrific idea.

Mr. **Anthony**. The only thing you would not be supportive of is if you saw an abuse of the concept?

Secretary **Brady**. It is my understanding that the vesting of the employees doesn't happen right away. We want to make sure when it does happen, it is ironclad.

Mr. **Anthony**. I have developed other suggestions as a result of visiting with entrepreneurs and constituents. I want to quickly mention them to you and get a brief reaction from you on them.

Eighty-percent tax on arbitrage gain. In other words, the arbitrage puts a stock in play, you hit him with an 80-percent tax on his gain?

Secretary **Brady**. The offset there is that if you do that, you have removed a lot of liquidity from the market giving us both sides of the argument here. The vibrancy and liquidity of our markets is what foreigners think is attractive and what our large institutions think is attractive, however, and that turnover probably is generative of tax revenues to the market as well.

If you put that kind of a tax in, you have decreased liquidity in the market. That would be an important thing to consider as you did it.

If you did do it, you would, obviously, decrease the amount of arbitrage activity that took place.

Mr. **Anthony**. Another suggestion has been before stock is put into play that the source of financing would be locked up and made public. For instance, you see some tender offers made to stockholders that say I would like to buy your stock for $50 a share if some financing would become available. Then, the shareholder accepts the offer, and the acquirer can't get the financing.

Secretary **Brady**. The processing might take a little longer. The truth of the matter is financing methods for these takeovers are in place.

If you set it out so that you couldn't make acquisitions subject to financing, you would slow it down some.

Mr. **Anthony**. It is my understanding from both news accounts and also from the takeover papers that have been filed with the regulatory agencies, that the board of directors, RJR Nabisco, will be paid in 5 years by either party.

It doesn't make any difference who took them over, whether inside management took them over or whether KKR took them over.

Five years nonproductive, doing nothing other than just getting a check for 5 years for not making any corporate decision, is that good policy?

Secretary **Brady**. I don't know that that is the case.

Is that the case?

Mr. **Anthony**. It is my understanding. Maybe you could have some of your staff check it out and see if it is, in fact, contained within the documents.

It is my understanding that directors will get paid $55,000 a year for doing nothing, no matter who takes over.

Secretary **Brady**. I would prefer to check into that.

Mr. **Anthony**. Would you check into it and make some statement of fact into the record and write whether or not you think that is good public policy?

[The following was subsequently received:]

RJR NABISCO BOARD OF DIRECTORS RETIREMENT PLAN

The Securities and Exchange Commission staff has informed us that the RJR Nabisco retirement plan provides that directors who retire after 5 or more years service on the board are entitled to full compensation (approximately $55,000 per year) for 10 more years. In July 1988, the plan was amended and restated to provide that it cannot be altered in the event of a change of control. Thus, in the event of a takeover, the retirement plan in effect becomes vested since the new board cannot change it. This is somewhat different from a so-called golden parachute where benefits are contingent upon a change of control.

In October 1988, the plan was amended again to set up a trust to fund it. Neither amendment changed the dollar amount of benefits payable under the plan. The terms of the plan, including these amendments, were disclosed to shareholders in proxy statements.

Employment and retirement benefits are generally a matter of private contract and State law. Thus, it would be inappropriate for me to comment.

Mr. **Anthony**. That is where my constituents talk a lot about the word "greedy." I am seeing whether it is good fiduciary capacity or bad fiduciary capacity.

Deducting only 6 percent of debt interest and correspondingly charging a tax on interest, you would support that?

Secretary **Brady**. Right.

Chairman **Rostenkowski**. Mr. Sundquist may inquire.

Mr. **Sundquist**. Thank you, Mr. Chairman.

Mr. Secretary, a couple of quick questions. In your opening testimony you emphasized that we have to guide our analysis on LBO and take into consideration the competitiveness of our U.S. companies.

I think we should be rightfully concerned that we don't want to put our U.S. companies at a disadvantage.

A couple of quick questions about how other countries are doing it. I think Congressman Shaw alluded to this earlier.

The LBO's have not been used seemingly in the acquisitions that have taken place in the common market countries, Europe. How do you account for that?

Secretary **Brady**. Well, because there isn't any junk bond market and there isn't any arbitrage activity, the machinery for getting the job done doesn't exist.

Mr. **Sundquist**. Do you anticipate it will there?

Secretary **Brady**. Really no, not to the same degree as the United States because you have less double taxation of dividends. You have to have incentives for people to create those markets.

The creation of those activities is driven by the inequities between equity and debt.

Mr. **Sundquist**. The second question relates to the Japanese. Their banks have provided a sizable amount of funds that have been used to finance acquisitions in this country. Seemingly, there are no acquisitions in Japan. How do you account for this?

Secretary **Brady**. Well, Congressman Sundquist, the system in Japan is so much different than it is in the United States. It is really hard to make comparisons.

First of all, the Government in a sense does have a no-fail policy in Japan. I mean they really do have.

They have much higher debt ratios than we do, and they have a policy which indicates that they will help corporations when they get into trouble.

Second, everybody owns part of everybody else in Japan. You not only own part of the debt, you own part of the equity.

There is a lot of cross-ownership and stuff like that. I think it is hard to compare.

I am not at this moment exact, do not exactly have in my mind what the relationship is between the taxation of debt and the taxation of equity.

I think because everybody owns part of it, it is not a problem. The guy who owns stock owns debt as well, so he gets some of each.

Mr. **Sundquist**. Thank you.

Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Moody.

Mr. **Moody**. Thank you, Mr. Chairman.

Mr. Secretary, we all appreciate your comments and the spirit with which you have been presenting your ideas.

I would like to take Mr. Shaw's point one step further. You obviously have a strong belief that the differential tax treatment between equity and debt is a major contributing factor to what we are seeing. That differential has been around a long time.

Between 1978 and 1983, we had $11 billion worth of LBO's. But between 1983 and 1988, the value of LBO's exploded to $180 billion.

Surely there must be something going on besides the differential which has been with us during that whole period?

Secretary **Brady**. There, obviously, are other factors. The reason why is that it just took a long time for the system to get going. As it became clearer that this differential existed, then the arbitrage community started to exist whereby stock had been collected in one place. Then along came the junk bond community which provided the missing piece to the link.

The system took a little while to develop. That doesn't change my mind that the engine behind all that is the difference in equity and debt.

Mr. **Moody**. Let me move to another point. I guess we both agree that for the corporation, there is a close substitutability between raising the funds through equity versus debt.

They don't care that much. It is the after tax treatment that matters. Also for the investor there is a close substitution question whether he wants to lend the corporation fixed return capital or take an equity position.

In 1986 Congress, with the leadership of the Reagan Administration, changed the tax law substantially to reduce corporate tax rates from, at the margin, 48 to 34 percent which made, it seems to me, debt/equity less attractive from a tax point of view.

It lowered the tax value of debt financing. Debt financing, instead of lowering your tax liability to 24 cents on the dollar, lowered it to 34 cents on the dollar. It made debt less attractive relative to equity.

Yet, we see after the 1988 tax change an explosion of debt/equity. With the tax changes, after tax changes actually appeared to be the opposite effect as one would expect from your testimony. Do you have a comment on that?

Secretary **Brady**. Yes. Obviously, it is less attractive. However, I think that if you left, if the tax rate had been left where it was, the trend toward LBOs would have been quicker.

The amount of them done would be more right now. Still I agree that people who argue that this is not the—the fact of the matter still remains that if 34 percent of the taxes that used to go to the government were removed, that is still a big chunk.

The fact that it could have been 48 percent doesn't necessarily make the argument wrong that that is what the root cause is. I think if it had been left at 48, it would have happened sooner.

Mr. **Moody**. You agree the relative tax values of the system had been altered in the direction we would have——

Secretary **Brady**. I do.

Mr. **Moody**. Has the Treasury looked at the possible effects on interest rates from the change you are proposing? If, for instance, we make debt equity less attractive relative to equity financing, as we would under your proposal, and since there is a close substitutability to the investor, he would have to receive after tax earnings on his savings equal to those available to him in equity.

In other words, there would be an upward pressure on interest rates to attract the money in the market.

Secretary **Brady**. Mr. Congressman, I am not sure I agree. If you weren't allowed to deduct as much interest on debt, there would be less debt and less requirements for debt. More money would flow into equity. You could almost make the case interest rates would go down.

Mr. MOODY. How would they net out?

You have clearly less willingness to provide debt financing because of the phenomena. You also have slightly less demand. You are stressing the demand side of the debt market.

I am stressing the supply side. They both work in somewhat different directions. The net effect won't necessarily leave interest rates as they are?

Secretary BRADY. I think it might bring interest rates down.

Mr. MOODY. There are two separate forces at work here. If you would look at those two and how they might net out I think it would be helpful.

Secretary BRADY. My feeling would be if you limited the deduction on interest, therefore, there would be less people issuing debt. Therefore, there would be less debt money out there chasing the money available to invest in it. Because of that fact you would have a lower rate of interest is the way I would look at it.

Mr. MOODY. Because the after tax returns would have to be equalized for the investor.

Secretary BRADY. That would be the equity market, I think.

Chairman ROSTENKOWSKI. Mr. Gradison may inquire.

Mr. GRADISON. Thank you, Mr. Chairman.

Thank you, Mr. Secretary, for very valuable testimony. One of the major pieces of unfinished business at the time that the Tax Reform Act of 1986 was written was to deal with this interest versus—pardon me—this debt service/equity question.

Both Treasury I and Treasury II suggested some modest steps in that direction, very modest, that indeed, were never adopted. It seems to me that the problem that we are talking about today rather than being used as a way to say you just keep an eye on it and see whether it requires, should instead be seen as creating an opportunity to correct and act upon the—correct a problem that we know exists which remains unfinished business from the writing of the Tax Reform Act of 1986.

I see this as a legislative opportunity to deal with a problem that has been with us for a long time.

I will have my own separate opportunity to testify later today, but I wanted to just simply outline the specific proposal that I am going to lay before the committee with—I am not asking for any immediate reaction.

I know you are looking into all the alternatives, and I am sure you will take a look at this one.

It bothers me the discussion of this issue for the recent months has been that it has been in a very broad and conceptual mode rather than looking at or referring to specific numbers.

I asked the Joint Committee some time ago to advise me of what rate of deduction would produce a revenue neutral result if applied currently against both dividends and interest.

Frankly, I was quite surprised by the answer because it is a much higher percentage of deductibility than I would have anticipated. Specifically, their statements, subject to all the appropriate conditions, that it is tentative and preliminary, and all that, and recognizing the Treasury would want to work the figures themselves, is 80 percent. That is to say the disallowance of 80 percent—the disallowance of 20 percent of interest paid by corporations, which would permit the deduction, the continued deduction of 80 percent interest paid by corporations, would on a revenue-neutral basis at the current time, permit a deduction of 80 percent of dividends paid.

It seems to me that if those numbers or something close to them hold up and if this could be phased in over a longer period of time, say, 10 years, that there may be the opportunity for action here in a way which gives the parties involved a chance to live with the system.

I don't honestly think that it is an overwhelmingly abrupt change to say next year, folks, instead of being able to deduct 100 percent of interest to 0 percent of dividends, you will be able to deduct 98 percent of interest at 8 percent of dividends, and so on.

I wanted to mention this because I, to me these numbers suggest that it might be wise to keep open the possibility of, to keep this on the front burner rather than say, well, we are going to keep an eye on it and we will see if something is really needed. Something is needed.

We have known it was needed. The Treasury acknowledged that action was necessary when we worked on the tax reform act, but we didn't get around to doing it then.

Thank you for listening.

Chairman Rostenkowski. Mr. Secretary, I think we have met our target except that Mr. Pickle would like 2 minutes for an admonition of sort, I guess, to both you and the chairman.

Mr. Pickle. Well, thank you for yielding.

I hope I am not cutting anybody else off.

Mr. Secretary, I think you need more manpower in the Treasury to analyze what is going on with LBO's and mergers and acquisitions.

I don't think you really know what is going on. Somebody should know what is going on.

It seems to me like we all agree between the Treasury and us, the Congress, what kind of help you need initially, and we ought to try to give it to you if we can do that.

Secondly, I think all we are saying to you, in line with your position, is that we are trying to stop the Tax Code from being used as a big motivation.

If you make the Tax Code neutral, then you may solve this problem. You can restrict the interest deduction. That sure would stop it.

Nobody in this room or in America believes most LBO's would go forward if you didn't have all these big amounts of interest to deduct. You are not going to do it with relief against double taxation on dividends, because that would ruin your budget. If we said we would do away with that, it costs you somewhere around $50–$60 billion at the least. We are not going to do that without covering the cost.

But if you could reduce deductions for interest and apply the savings to a deduction on dividends, it would be revenue neutral.

There is a point in which you can establish that deduction of interest and balance it with the dividend deduction, and you could make an even playing field.

If you did that, you would do away with the big problem of junk bonds.

It seems to me the only big question we have got left then would be how do you handle foreign investments?

How can we protect our country? It would seem to me like if you would give us a recommendation then I think we have something to work on.

It would seem to me like if you give us some leadership in this, we will try to match it and see if we can find a better answer.

Chairman **Rostenkowski**. Thank you, Congressman.

Mr. Secretary, by the amount of participation among the Members on the Ways and Means Committee, I imagine you understand the interest that has been generated, and I think most of us are very concerned about the sensitivity of legislation in this field.

We certainly don't want to do anything to cause an economic downturn. We understand the sensitivity of the legislation.

I just want to pledge to you that any way that we can be helpful to putting something together that can solve the problem, maybe change the policy, this is a broad field.

The Ways and Means Committee doesn't have exclusive jurisdiction.

I think that we have the most meaningful jurisdiction because we certainly get their attention when we change the code.

I want to thank you very much for helping us out and joining us this morning. I am hoping we will have a very, very healthy and worthwhile relationship with the Treasury Department and your leadership there.

Secretary **Brady**. I am sure we will. I thank you for giving me this much time.

[The following questions from Congressman Coyne and responses from the Department of the Treasury were subsequently received:]

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COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, DC 20515

February 21, 1989

The Honorable Nicholas F. Brady
Secretary of the Treasury
U.S. Department of the Treasury
Washington, D.C. 20220

Dear Mr. Secretary:

To complete the record on the hearings on Tax Policy Aspects of Mergers and Acquisitions, held on January 31, and February 1 and 2, Representative Coyne has asked that you answer the enclosed questions. It would be appreciated if you would supply these answers to the Committee office, 1102 Longworth House Office Building, to the attention of Diane Kirkland, by Tuesday, March 21, 1989.

Thank you for your cooperation in this matter.

Sincerely,

Dan Rostenkowski

Dan Rostenkowski
Chairman

DR/dk

Enclosure

cc: The Honorable William J. Coyne

Questions for Nicholas Brady, Secretary of the Treasury

From William Coyne, M.C.

According to a report that appeared in the New York Times on December 23, 1988, the commission of the European Community has proposed legislation that would harmonize rules on corporate takeovers for its twelve member nations. Has the Treasury studied this proposed legislation for ideas that might help the United States?

If it were possible to totally eliminate the differential treatment of equity and debt in the Tax Code, do you think that change would be sufficient to end the current LBO wave?

The Ways and Means Committee heard testimony from a number of witnesses, including yourself, that indicated that the need to meet large debt-service requirements for mergers and acquisitions financed primarily with debt may have a negative impact on the competitiveness of the United States in the world market. It has been suggested that leveraged acquistions have large claims on a corporation's cash flow and that the interest payments draw funds away from such uses as upgrading capital equipment and R & D. Would you agree that the federal goverment has cause to continue to be concerned about leveraged buyouts and corporate debt even if the recent wave of LBOs has crested?

DEPARTMENT OF THE TREASURY
WASHINGTON

May 10, 1989

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

In a letter of February 21, you asked Secretary Brady to respond to three questions submitted by Representative Coyne in order to complete the record for the January 31 hearings before the House Ways and Means Committee on Tax Policy Aspects of Mergers and Acquisitions. A brief restatement of the questions and Secretary Brady's answers follow.

The first question asks whether a report by a commission of the European Community might offer ideas applicable to our study of the tax aspects of mergers and acquisitions. This report, entitled "Proposal for a Thirteenth Council Directive on Company Law concerning takeovers and other general bids," addresses securities law issues rather than tax issues and thus does not provide a source for possible United States tax legislation.

The second question asks whether eliminating the differential treatment of debt and equity would be sufficient to end the current LBO wave. As Secretary Brady stated during his testimony before your committee, it is his view that the differential treatment of debt and equity under the Internal Revenue Code is the mill in which the grist of takeover premiums is ground. Thus, the Secretary believes that ending this differential treatment would have a significant impact on the current level of LBO activity.

The third question asks whether, because of the effect on capital expenditures and R & D, the federal government has cause to continue to be concerned about leveraged buyouts and corporate debt even if the recent wave of LBOs has crested. For the reasons stated in his testimony before the Committee, the Secretary agrees that there is cause for continued concern. Nonetheless, the Secretary also continues to believe that it is premature to attempt to legislate a solution at this time.

I hope this information assists you in completing the record on the hearings.

Sincerely,

Mary C. Sophos

Mary C. Sophos
Deputy Assistant Secretary
(Legislative Affairs)

cc: The Honorable William J. Coyne

Chairman ROSTENKOWSKI. The next panel, please.

Mr. Ruder, Chairman of the Securities and Exchange Commission. Mr. Robert Clarke, Comptroller of the Currency. Mr. William Seidman, Chairman, Federal Deposit Insurance Corporation; and Ms. Kathleen P. Utgoff, Executive Director, Pension Benefit Guaranty Corporation.

Could I ask the public to withdraw from the committee room as quietly as possible?

First of all to this panel let me express my appreciation for your patience.

I know that you as well as many people here in this hearing room have other things that you could be doing. I guess you recognize the gravity of the situation which we find ourselves in.

I want to apologize first for having delayed so long your appearance, but I want you to know how much we appreciate your participation.

I think what we will do, as we have in the past, is ask each of you, beginning with Mr. Ruder to start off.

We will follow the order in which you appear on the notice.

Immediately after your testimony we will get into an exchange. We will ask questions.

If you have anything that you can add in a discussion to help us, we would appreciate it.

Mr. Ruder.

STATEMENT OF HON. DAVID S. RUDER, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. RUDER. Thank you, Chairman Rostenkowski and members of the committee.

I appreciate this opportunity to present the views of the Securities and Exchange Commission. I ask that the written statement of the Securities and Exchange Commission be entered into the record.

Chairman ROSTENKOWSKI. The entire statement will be entered into the record if you would like to summarize.

Mr. RUDER. Thank you.

The term leveraged buyouts has been discussed here this morning. It describes a large variety of corporate transactions that substitute debt for equity. Within that term I would include highly leveraged going private transactions, hostile tender offers, mergers and recapitalizations.

Frankly, all corporate acquisitions today are leveraged. During the past 2 years the number and value of these transactions have increased. During the 1980s leveraged buyouts have created significant wealth gains for shareholders in U.S. corporations.

Premiums over market values received by shareholders of acquired companies have been in the 30 to 40 percent range. According to a study by Professor Jensen of Harvard, shareholder gains resulting from all types of corporate control transactions occurring between 1977 and 1986 totaled approximately $301 billion.

SEC Commissioner Grundfest found that between 1981 and 1986 takeovers of publicly traded corporations, divestitures and leveraged recapitalizations produced increases in shareholder wealth totaling at least $162 billion.

The Commission's Office of Economic Analysis has determined that premiums resulting from going private transactions totaled at least $38 billion during the last 10 years.

To the extent these shareholder gains have been reinvested in our securities markets, these transactions have increased available financial capital and facilitated capital fund raising for other issues of securities.

Notwithstanding the beneficial effects of leverage buyouts for shareholders, these transactions raise numerous public policy questions, including the extent to which reduced tax liabilities fund LBO's, the extent to which LBO's merely transfer wealth from bond holders to shareholders, the effects of LBO's on research and development and upon corporate profitability, the exposure of federally insured deposit institutions to LBO debt; and the danger that highly leveraged companies will be overly exposed in times of recession.

Although all of these questions deserve the benefit of public discussion, the Securities and Exchange Commission is primarily concerned with the adequacy of the disclosure in LBO transactions.

In management leveraged buyouts, the Commission has focused on the special issues presented by the potential conflicts of interest and informational advantages of management in dealing with their own shareholders.

The Commission has adopted an extensive disclosure scheme to address those concerns. Commission Rule 13e-3 provides shareholders with information relevant to assessing the fairness of management leveraged buyouts.

This information assists shareholders in making investment decisions and in deciding whether to utilize state law substantive and procedural protections governing conflicts of interest questions.

The Commission's staff has been monitoring State law developments and will continue to do so. In addition, it is currently considering whether to extend fairness disclosure rules to all negotiated transactions.

The Commission's investor protection concerns go beyond the interest of shareholders in the subject company. Recent events demonstrate that the subject companies' bondholders are also at risk in these transactions.

Our staff is examining current disclosure requirements to ascertain whether bond holders are receiving adequate and timely disclosure concerning the possibility that a leveraged transaction might occur.

Other areas that will be examined are the adequacy of disclosures to those who invest in LBO debt and to investors in financial institutions that hold high concentrations of LBO debt.

In addition to analyzing disclosure issues, the Commission is currently reviewing available economic data for the purpose of addressing a variety of questions regarding the effects of LBO transactions. We are gathering data from firms engaged in LBO transactions.

We hope to be able to provide some helpful conclusions regarding the effects of these transactions in the near future.

My written testimony describes the various disclosure issues that the Commission staff is presently studying. Upon completion of this study, and our economic study, the Commission will determine whether rulemaking or legislative proposals or other actions are necessary.

Thank you.

[The statement of Mr. Ruder follows:]

STATEMENT OF DAVID S. RUDER CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION, BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS CONCERNING LEVERAGED BUYOUTS

Chairman Rostenkowski and Members of the Committee:

I appreciate this opportunity to present the views of the Securities and Exchange Commission on the important issues for the nation's securities markets and economy as a whole presented by leveraged buyouts ("LBOs").

The term "leveraged buyout" has been used to describe a variety of transactions. Practically all corporate acquisitions today are leveraged to some extent. They may be conducted by management, corporate affiliates, or third parties. They may be hostile or friendly. They may be conducted by tender offer or negotiated merger. They may involve the sale of assets or securities. 1/ For purposes of understanding the area under discussion, all of these leveraged transactions have a common characteristic: assets of the subject company are used as collateral for a loan that is obtained to pay all or part of the purchase price of the company or to accomplish a restructuring of the company. 2/

Leveraged buyout transactions recently have attracted particular public attention. Perhaps the most notable example is the pending acquisition of RJR Nabisco by Kohlberg Kravis Roberts & Co. ("KKR"). One measure of LBO activity is the "going private" transaction. In "going private" transactions, shareholders of publicly held corporations are bought out, typically at a large premium, by a bidder who takes a concentrated ownership position in a reconstituted, privately held firm. The Commission's staff has collected data on the number and pre-transaction equity value of

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1/ In addition, many leveraged transactions undertaken to recapitalize or restructure a corporation present many of the same disclosure and economic issues as leveraged acquisitions. For example, Proctor & Gamble's recent decision to increase the funding of its ESOP by $1 billion through increased borrowings, issuance of preferred shares, and a stock buyback constitutes a leveraged transaction. Schellhardt, "P&G to Boost Its Employees Stake to 20%," Wall St. J., January 12, 1989.

2/ See Leveraged Buyouts and the Pot of Gold: Trends, Public Policy, and Case Studies, A Report Prepared by the Economics Div. of the Congressional Research Service for the House Subcomm. on Oversight and Investigations of the Comm. on Energy and Commerce, 100th Cong., 2d Sess. (Dec. 1987) (Comm. Print No. 100-R) (hereinafter Leveraged Buyout Trends).

companies that went private during 1980-1987. 3/ The number of going private transactions increased from 101 during the first four years of this period to 169 during the last four years. Similarly, the total equity value of firms that went private increased from $10.26 billion during 1980-1983 to $54.24 billion during 1984-1987. Approximately 84% of the value of going private transactions during 1980-1987 occurred during the last half of this sample period.

The data also reveal that the average size of firms going private increased over this period. The mean equity value of these firms increased from $101.6 million during the first four years to $321.0 million during the last four years. The latter half of this period was characterized by several going private transactions involving large companies, including Beatrice Co., Safeway Stores, R.H. Macy, and Owens-Illinois. 4/

Finally, the Commission's staff found that the value weighted average premium corresponding to these transactions was approximately 32.2%. Using some simplifying assumptions, the staff estimates that more than $20 billion in premiums

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3/ *See* Table 1. Management buyouts of divisions of public corporations are also frequently referred to as going private transactions or leveraged buyouts. The data in Table 1 do not include these transactions and are based solely on going private transactions of publicly traded, free-standing companies.

For transactions completed during 1988 having a value greater than $100 million, the increase in equity value after the transaction was 54.4%.

4/ Significant differences exist across industries in the number and equity value of companies that went private during 1980-1987. The industry with the largest number of going private transactions was food and kindred products (22), followed by textile mill products (15), apparel (14), rubber and miscellaneous plastic products (14), and general merchandise stores (13). The equity value of companies that went private during this period was largest for food stores ($45.8 billion), followed by food and kindred products ($4.8 billion), communications ($3.8 billion), general merchandise stores ($3.4 billion), and transportation equipment ($3.1 billion).

were paid to stockholders in going private transactions during 1980-1987. 5/

The federal securities laws protect investors in these transactions by mandating the disclosure of material information. Perhaps of principal significance are the tender offer and merger proxy rules that are designed to provide the subject company's shareholders with information concerning the transaction in which they are asked to sell their securities. The disclosure concerns generated by highly leveraged transactions, however, reach beyond the interests of the subject company's shareholders and affect holders of senior debt securities, as well as investors in the leveraged buyouts who can be either purchasers of the debt securities issued to finance the transaction or equity participants in the surviving entity. In addition, investment vehicles that allow small investors to participate in these transactions indirectly and on a diversified basis through so-called "junk bond" 6/ and LBO mutual funds, or through employee stock ownership plans, raise significant disclosure concerns. Further, to the extent that publicly-held institutions are the source of financing for these transactions, the potential effect on investors in banks, thrifts, insurance companies, broker-dealers, and investment banking firms also must be considered.

Management-led leveraged buyouts ("MBOs") also present questions of fairness, because management has an inherent informational advantage over nonaffiliated shareholders and is presented with conflicts of interest when dealing with their corporation's own shareholders. The Commission has focused on those issues at least since 1975 and has adopted a detailed disclosure scheme designed to protect the interests of shareholders in those situations.

5/ This estimate was computed as the average premium (36.84%) multiplied by the pre-transaction equity value of companies that went private during this period ($54,921.3 million). The staff presently is computing the value of these premiums, transaction by transaction, which will allow for a more precise estimate of aggregate premiums.

6/ The term "junk bond" is used to refer to high-yield, non-investment grade bonds. Because they carry more risk, junk bonds, which are also sometimes referred to as "high-yield bonds," must pay a higher rate of interest to attract investors.

Finally, the proliferation of leveraged buyouts in the 1980s has raised several economic policy issues reaching beyond the scope of the securities laws, including the following:

(1) Tax Policy - To what extent does the existing tax code encourage corporate debt generally, and leveraged buyouts in particular?

(2) Participation of Federally Insured Institutions - Are federally insured deposit institutions investing "excessively" in the debt used to finance leveraged buyouts?

(3) Macroeconomic Policy - Will the debt used to finance leveraged buyouts and corporate restructurings exacerbate an economic downturn?

(4) Corporate Performance - What effect do leveraged buyouts have on corporate profitability, wages and employment, and expenditures on research and development?

Although all of these issues will be investigated by legislators and regulators during the next several months, the Commission's testimony today will focus on disclosure issues that have been raised by LBO activity. The Commission's staff will continue to generate data on leveraged buyouts to assist in ongoing policy discussions.

I. Disclosure Requirements Under the Federal Securities Laws Governing Leveraged Buyouts

The nature and extent of the disclosure requirements governing a leveraged buyout depend on both the type of transaction chosen to accomplish the acquisition and the affiliation of the participants in the transaction. In addition, different disclosure schemes exist to protect different classes of investors.

A leveraged buyout can be accomplished through a negotiated merger, a third-party tender offer, an issuer self-tender offer, a sale of assets, a reverse stock split and repurchase of resulting fractional interests, a payment of a large extraordinary dividend financed by borrowings and resulting in a disproportionate change in ownership, or any combination of these transactions. The financing for these transactions can be provided by a variety of means, each of which has different implications under the federal securities laws. These include a public offering of debt securities, an exchange offer of debt securities for the publicly-held common stock of the issuer, and a private placement of debt or equity securities, typically with institutional investors. Commercial banks often provide the senior financing secured by the target's assets and securities purchased in the transaction. 7/ With the increased size of leveraged buyouts, equity financing frequently is provided through the placement of limited partnership or other equity interests, again frequently with institutional investors.

This section outlines the current federal securities law disclosure requirements with respect to leveraged buyouts. Subsequent sections focus on other federal securities law concerns raised by leveraged buyouts and on the role of state law in protecting the interests of investors in these transactions.

A. Tender Offers

Third party and issuer tender offers are governed by provisions of the Securities Exchange Act of 1934 added by the Williams Act Amendments of 1968, 8/ and the Commission's rules adopted thereunder, which are designed to require disclosure of material information to the marketplace and to protect the ability of public shareholders to act on that information. With respect to third party tender offers, Regulations 14D and 14E 9/ prescribe detailed procedural and disclosure requirements for third party tender offers, including a minimum offering period, withdrawal and proration rights, and protection to ensure equal treatment of all shareholders. The bidder is required to file a Schedule

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7/ *E.g.*, "Banks Offer Glimpse at LBO Portfolios, Showing that Many Loans Are Resold," Wall St. J. Dec. 13, 1988, p. A3. *See* Memorandum of Robert L. Clarke, Comptroller of the Currency, to Chief Executive Officers of All National Banks, dated December 15, 1988 (setting forth examination guidelines to be used by OCC examiners to assess bank lending activities in connection with all forms of highly leveraged transactions).

8/ The Williams Act, enacted in 1968 and amended in 1970, added Sections 13(d), 13(e), 14(d), 14(e), and 14(f) to the Securities Exchange Act. Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454; Act of Dec. 22, 1970, Pub. L. No. 91-567, 1, 2, 84 Stat. 1497 (codified at 15 U.S.C. 78m(d)-(e) and 78n(d)-(f) (1970)).

9/ Regulation 14D, 17 CFR 240.14d-1 *et seq.*; Regulation 14E, 17 CFR 240.14e-1 *et seq.*

14D-1 10/ and to disseminate to shareholders a disclosure document containing information concerning the identity and background of the bidder, the purpose of the transaction, any agreements or understandings with respect to the issuer's securities and, where material, financial statements. Commission Rule 14e-2 11/ requires the target company to respond to the offer and any revised offer and discuss the reasons for its position with respect to the offer, as well as any negotiations it has commenced in response to the offer.

Of particular relevance in the leveraged buyout context is the requirement that the bidder disclose the source and amount of financing for the acquisition. 12/ While a bidder need not have its financing in place at the time it commences the offer, the obtaining of a significant portion of this financing represents a material change that requires dissemination of that information and possibly an extension of the offer. 13/ A bidder in an LBO also must disclose any plans to liquidate or sell the subject company's assets or subsidiaries or change its capital structure or business. 14/

Rule 13e-4 15/ prescribes substantially identical requirements with respect to issuer tender offers, including the filing of a Schedule 13E-4. 16/

Securities issued as consideration in the tender offer must be registered under the Securities Act of 1933, unless an exemption is available. The securities usually will be

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10/ 17 CFR 240.14d-100.

11/ 17 CFR 240.14e-2.

12/ 17 CFR 240.14d-100, Item 4.

13/ See IU International Corp. v. NX Acquisition Corp., 840 F.2d 220 (4th Cir. 1988); Newmont Mining v. Pickens, 830 F.2d 1448 (9th Cir. 1987). See also Letter dated March 28, 1988, from Daniel L. Goelzer, General Counsel of the Securities & Exchange Commission, filed in R.H. Macy & Co. v. Campeau Corp., 683 F. Supp. 422 (S.D.N.Y. 1988).

14/ 17 CFR 240.14d-100, Item 5.

15/ 17 CFR 240.13e-4.

16/ 17 CFR 240.13e-101.

registered with the Commission on Form S-4. 17/ In contrast, pursuant to Section 3(a)(9) of the Act, an issuer's offer to exchange securities for an outstanding class of its own shares generally does not require that those securities be registered, unless fees or commissions are paid to persons soliciting the exchange. 18/

B. Merger Transactions

A leveraged buyout also can be carried out solely as a merger transaction 19/ or as a two-step transaction involving a tender offer followed by a merger transaction to acquire the non-tendered shares. 20/ A negotiated merger transaction generally will involve a proxy solicitation subject to the proxy rules under Regulation 14A adopted by the Commission pursuant to Section 14(a) of the Securities Exchange Act. 21/ The proxy rules are intended to provide the shareholders of the affected corporations adequate information upon which to make an informed voting decision. The proxy rules require the filing with the Commission and the dissemination to shareholders of a proxy statement containing information called for by Schedule 14A. 22/ In particular, Schedule 14A requires extensive disclosure concerning the merger

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17/ Form S-4, adopted in Securities Act Release No. 6578 (April 23, 1985) [50 FR 18990].

18/ 15 U.S.C. 77c(a)(9).

19/ *E.g.*, First Boston Inc., Definitive Proxy Materials filed December 2, 1988.

20/ *E.g.*, Schedule 14D-1 filed by KKR for the common stock of RJR Nabisco, Inc., filed October 27, 1988; Schedule 14D-1 filed by Morgan Stanley & Co. for the common stock of Burlington Industries, filed May 26, 1987.

21/ Section 14(a) of the Securities Exchange Act applies where proxies are solicited from holders of securities registered under Section 12 of the Securities Exchange Act, 15 U.S.C. 78l. Section 14(a), 15 U.S.C. 78n(a). *See also* Regulation 14A of the Securities Exchange Act, 17 CFR 240.14a-1 *et seq*. Regulation 14C of the Securities Exchange Act, 17 CFR 240.14c-1 *et seq*., adopted under Section 14(c) of the Exchange Act, 15 U.S.C. 78n(c), requires that the issuer disseminate an information statement if it does not solicit proxies with respect to matters to be acted upon at a meeting.

22/ 17 CFR 240.14a-101.

transaction and the parties to the transaction, including detailed historical and pro forma financial information. 23/ As with tender offers, if all or part of the consideration will consist of securities, absent an exemption from registration, the securities must be registered with the Commission on Form S-4.

C. Going-Private Transactions

As discussed more fully in the following section, if the issuer or an affiliate undertakes a tender offer or merger that results in a class of equity securities no longer being publicly held (a "going-private transaction"), Commission Rule 13e-3 24/ imposes an additional level of disclosure concerning the purpose of the transaction and the fairness of the transaction to nonaffiliated shareholders. This rule requires reasonably detailed disclosure of not only the terms of the transaction, but, in addition, detailed disclosure of the process under which those terms were arrived at, including alternatives considered and the factors upon which the required assessment of fairness by the company or its affiliate is based. In addition, Rule 13e-3 requires shareholders to be informed of, among other things, the identity of any affiliates engaged in the transaction; the nature of any contracts or arrangements made by or between the issuer and affiliates with third parties with respect to the issuer's securities; and the source of funds.

These requirements are designed to provide the shareholders of a corporation who are asked to sell their corporation to its management with information necessary to make that decision. The disclosure requirements apply to an acquisition of shares by an issuer or affiliate, a proxy solicitation with respect to any other business combination, recapitalization, reorganization, or similar transaction by an issuer or between an issuer and an affiliate, a sale of substantially all of the issuer's assets to an affiliate, or a reverse stock split involving the purchase of fractional shares, if such a transaction is part of a going-private transaction.

23/ 17 CFR 240.14a-101, Item 14.

24/ 17 CFR 240.13e-3. Securities Exchange Act Rule 13e-3 applies to specified transactions involving an equity security of an issuer that has any equity security registered under Section 12 of the Act, 15 U.S.C. 78l, or is required to file reports under Section 15(d) of the Act, 15 U.S.C. 78o(d), or is a closed end investment company registered under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq. *See infra* n.48.

D. Registration Requirements

Before a company that is engaged in or may be considering a leveraged buyout sells its securities, or an acquiror sells securities to finance a leveraged acquisition, Section 5 of the Securities Act 25/ requires that a registration statement be filed with the Commission and declared effective, unless an exemption from the registration requirements is available. Debt and equity securities issued to finance leveraged buyouts often will not be subject to Commission disclosure or filing requirements, since they frequently are issued in exempt private offerings. Section 4(2) of the Securities Act 26/ exempts transactions by an issuer of securities not involving a public offering. Limited offerings to sophisticated investors are exempt from the registration requirements without regard to the dollar value of the offering. 27/ These private placements of securities generally are conducted through the use of an offering circular that is not subject to specific disclosure requirements, but is subject to the antifraud and civil liability provisions of the securities laws. 28/ Debt issued in these private placements is often subsequently registered for resale in secondary offerings, at which point a registration statement is filed and full public disclosure must be made.

When no exemption from registration is available, the issuer of the securities must file a registration statement. The registration process provides investors with detailed information concerning, among other things, the issuer and the nature of its business operations -- including the issuer's audited financial statements and, in certain cases, pro forma financial statements 29/ showing the effects of the

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25/ 15 U.S.C. 77e.

26/ 15 U.S.C. 77d(2).

27/ SEC v. Ralston Purina Co., 346 U.S. 119 (1953). See also Rule 506 of Regulation D under the Securities Act, 17 CFR 230.506.

28/ Preliminary note 2 to Regulation D under the Securities Act, 17 CFR 230.501. See infra Section I.F.

29/ See Article 11 of Regulation S-X [17 CFR 210.11-01 through 210.11-03]; Item 503(d) of Regulation S-K [17 CFR 229.503(d)]. Pro forma financial statements are usually required in a registration statement for the (continued...)

transaction -- the terms of the security, the use of proceeds, and the risks involved in the investment. Where the issuer intends to use the proceeds to finance the acquisition of other businesses, the identity of the businesses, or if the identity is not known, the nature of the businesses, and the status of any negotiations, must be stated. 30/ An exception to the requirement to provide a detailed discussion of the acquisition is provided for circumstances where pro forma financials otherwise would not be required and the disclosure would jeopardize the acquisition. 31/

E. Periodic Reporting Requirements

Apart from the transactional disclosure requirements of the federal securities laws discussed above, an issuer with a class of securities registered with the Commission under Section 12(b) or 12(g) of the Exchange Act 32/ is subject to the continuous reporting requirements of Section 13(a) of the Act. 33/ In addition to companies registered under Section

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29/(...continued) issuance of securities concurrently with a leveraged buyout or subsequent to such a transaction. Such pro forma financial statements would reflect the change in the capital structure as a result of the leveraged buyout, the revaluation of assets and the identification of any goodwill created in the purchase, and adjustments to the income statement to give effect to increased interest and depreciation costs and reductions in income tax expense. If plans exist for the disposition of assets, the pro forma balance sheet would give effect to the terms of the disposition of those assets and the income statements would reflect the effect on revenues and expenses that would result from the disposition.

30/ Item 504 of Regulation S-K [17 CFR 229.504].

31/ *Id.* at Instruction 6.

32/ 15 U.S.C. 78l(b) and 78l(g). Section 12(b) of the Securities Exchange Act requires companies to register any class of security listed on an exchange whereas Section 12(g) of the Securities Exchange Act and Securities Exchange Act Rule 12g-1 thereunder, 17 CFR 240.12g-1, requires registration of any class of equity security that is held by at least 500 persons if the issuer has total assets exceeding $5,000,000.

33/ 15 U.S.C. 78m(a).

12, companies that conduct a registered public offering are required by Section 15(d) of the Exchange Act to file reports for the year their registration statements become effective and thereafter until the securities are held by less than 300 persons.

Sections 13(a) and 15(d) and the Commission's rules and regulations thereunder are intended to provide timely dissemination of material information to investors and the marketplace by requiring registrants to file annual, quarterly, and current reports with the Commission. 34/ The annual report on Form 10-K contains three-year audited financial information and other information about the registrant's business, management, and financial condition. Quarterly reports on Form 10-Q are filed for the first three quarters of a registrant's fiscal year and contain, among other matters, unaudited financial information. Registrants also are required to file current reports on Form 8-K to disclose significant events, including the acquisition or disposition of a significant amount of assets and or change in control of the registrant that has not been previously reported in another filing made with the Commission. 35/

F. Antifraud Provisions

In addition to the specific affirmative disclosure obligations imposed by the tender offer, proxy, registration, and periodic reporting requirements, the federal securities laws contain broad antifraud provisions applicable to leveraged buyouts. Although the specific language of the rules varies, they generally prohibit the making of false or misleading statements or the omission of material information necessary to make other statements made not misleading. 36/

34/ Annual Report on Form 10-K under the Securities Exchange Act, 17 CFR 240.310; Quarterly Report on Form 10-Q under the Securities Exchange Act, 17 CFR 240.308a; Current Report on Form 8-K under the Securities Exchange Act, 17 CFR 240.308.

35/ 17 CFR 240.308, Items 1, 2 and 5.

36/ See Section 17(a) of the Securities Act, 15 U.S.C. 77q(a); Sections 10(b) and 14(e) of the Securities Exchange Act, 17 U.S.C. 78j(b), 78n(e) and Securities Exchange Act Rules 10b-5, 14a-9 and 14e-3 thereunder, 17 CFR 240.10b-5, 14a-9 and 14e-3. See also Securities Act Rule 408, 17 CFR 230.408 and Securities Exchange Act Rule 12b-20, 17 CFR 240.12b-20.

The Supreme Court in Basic v. Levinson recently reaffirmed that the materiality of a statement or omission requires an assessment of the specific facts and circumstances and will depend "on the significance the reasonable investor would place on the withheld or misrepresented information." 37/ In Basic, the Court considered whether misstatements concerning the status of preliminary merger negotiations violate the antifraud provisions. The Supreme Court adopted the test urged by the Commission and held that the materiality of merger negotiations depends on an assessment of "the probability that the event will occur" and the "magnitude of the transaction to the issuer." 38/ The same "probability/magnitude" approach should be applied to the question of when management's consideration of a merger or LBO transaction is material to the issuer's shareholders and debt holders.

Whether and when management has a duty to disclose that information is a separate question. In the absence of voluntary statements with respect to the subject, a company generally has no affirmative duty under the federal securities laws 39/ to disclose ongoing considerations of merger proposals or other potential acquisitions of the company and may elect to remain silent even if the information would be material to investors. 40/ In the absence of voluntary statements, disclosure is required only when a company is trading in its own stock, 41/ when the

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37/ 108 S. Ct. 978, 988 (1988). See also TSC Industries, Inc. v. Northway, 426 U.S. 438 (1976) (materiality under proxy rules).

38/ 108 S. Ct. at 987.

39/ Disclosure of significant transactions may be encouraged by the relevant listing standards promulgated by the stock exchanges. See, e.g., NYSE Listed Company Manual Section 202.05 (1987); AMEX Company Guide Sections 401-406 (1973).

40/ See Basic v. Levinson, 108 S. Ct. at 987 n.17; Jordan v. Duff and Phelps, Inc., 815 F.2d 429 (7th Cir. 1987), cert. dism., 108 S.Ct 1067 (1988).

41/ See generally Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980).

company is responsible for leaks to the market, 42/ or when the regulations promulgated by the Commission, such as those outlined above, require disclosure. Although a company generally has no duty to disclose ongoing consideration of a leveraged buyout, the existence of one or more of the various factors that may trigger disclosure obligations sometimes requires that disclosure be made.

G. Margin Requirements

Section 7 of the Securities Exchange Act 43/ empowers the Federal Reserve Board to prescribe rules limiting the amount of credit that may be extended for the purchase of securities. Regulation G generally prohibits a lender that is not a bank or a broker-dealer from extending credit for the purpose of purchasing or carrying margin stock ("purpose credit") that is secured directly or indirectly by margin stock, in an amount that exceeds 50 percent of its current market value. 44/

In an interpretation of Regulation G issued in 1986, 45/ the Board stated that debt securities issued by a shell corporation in connection with a takeover are presumed to be secured indirectly by the margin stock of the target corporation in the absence of certain defined circumstances allowing the lenders to look to the target company's assets for repayment. In defining the circumstances in which the presumption would not apply, the Board stated:

> [E]ven where a shell corporation is involved, lenders would not be relying on margin stock where the loan is guaranteed by an operating company with substantial assets or cash flow or where the borrower is an operating company with the characteristics.
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> The presumption that the debt securities are indirectly secured by margin stock would not apply if there is specific

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42/ See, e.g., State Teachers Retirement Board v. Fluor Corp., 654 F.2d 843, 850 (2d Cir. 1981).

43/ 15 U.S.C. 78g.

44/ 12 CFR 207.3(b), 207.7(a).

45/ 12 CFR 207.112 (Jan. 15, 1986) [51 FR 1771].

> evidence that lenders could in good faith rely on assets other than margin stock as collateral, such as a guaranty of the debt securities by the shell corporation's parent company or another company that has substantial non-margin stock assets or cash flow. 46/

The Commission is empowered to enforce the Federal Reserve Board's margin rules and interpretations. 47/ When the Commission staff becomes aware of a potential margin violation presenting significant policy or interpretive issues, it solicits guidance from the Board's staff.

II. Management Buyouts: The Commission's Regulatory Response

Management-led leveraged buyouts represent one of the principal uses of the leveraged buyout financing technique and a type of transaction that raises significant policy concerns. In an MBO, management either alone or, more typically, in conjunction with a group of outside investors (usually an LBO firm), acquires the company from its public stockholders in a going-private transaction of the type described earlier. 48/ The investor group normally contributes only a small portion of the actual purchase price and borrows the balance collateralized by the acquired company's assets. 49/ The management subsequently may take

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46/ 51 FR at 1774.

47/ 15 U.S.C. 78u.

48/ A "going-private transaction" is a transaction by the issuer or affiliates which results in the elimination of public ownership of a class of equity securities. See Securities Exchange Act Rule 13e-3(a)(3), 17 CFR 210.13e-3(a)(3) (definition of "Rule 13e-3 transaction").

49/ The financing structure of a typical MBO is as follows: 50% senior bank debt; 40% subordinated debt and 10% equity contributions. In return for its participation, the management group may receive 15-20% of the equity in the acquired entity. See, e.g., Schedule 13e-3 filed by Foodmaker Inc. on September 19, 1988.

the company public again in a so-called "reverse LBO," 50/ gradually liquidate all or significant parts of the acquired entity by actively pursuing a program of divesting the company's assets, 51/ sell the company to another firm or to an ESOP, 52/ or continue to operate the firm as a private entity. 53/ The large profits that these management and investor groups have realized on their investment activities have raised questions as to the fairness of MBOs both to the public shareholders whose stock has been purchased and to the public bondholders, whose securities may have declined substantially in market value because of the manner in which the MBO transaction was structured. 54/

50/ A "reverse LBO" is a transaction in which a company which is taken private goes public again in an initial public offering ("IPO"). In 1986, there were 30 such transactions. By 1987, the number had reached 45. In 1988, there was a reduction in the number of reverse LBOs due, in part, to the soft IPO market. During the first eight months of 1988, there were five such transactions. These figures include the sale by a public company of a division to its managers, who subsequently take the company public, which transactions may not pose the same concerns under the federal securities laws as the buyout of a public company. "Reverse LBOs Plunge, as Low Valuations, High P/E Ratios Keep Companies Away," 12 Going Public: The IPO Reporter at 1283, August 29, 1988. See generally Wayne, "'Reverse LBO's' Bring Riches," N.Y. Times, April 23, 1988, p. D7.

51/ See Johnson and Cohen, "Beatrice Buy-Out May Net Investors Five Fold Return," Wall St. J., September 4, 1987. But see Burrough and Johnson, "Profit From Sale of Beatrice May Be Cut By $1 Billion Due to Stock Market Crash," Wall St. J., Dec. 7, 1987, p. 8.

52/ Miller and Cohen, "Avis Inc. Is Sold For Fifth Time in Four Years," Wall St. J., September 29, 1987, at 3.

53/ Gilson, Scholes and Wolfson, Taxation and the Dynamics of Corporate Control: The Uncertain Case for Tax-Motivated Acquisitions at 271 (J. Coffee, L. Lowenstein & S. Rose-Ackerman, eds., Oxford Univ. Press, 1988).

54/ E.g., Herman, "RJR Still Haunts Corporate Bonds," Wall St. J., Dec. 14, 1988, at p. C1. Studies have indicated that bondholders suffer small wealth losses on average in going private transactions, but that these losses are far exceeded by shareholder gains. See Lehn & Poulsen,

(continued...)

A. Background of Rule 13e-3

The Commission has long been aware of the significant investor protection questions raised by MBOs. In September 1974, the Commission undertook a public investigation of beneficial ownership of securities and takeovers. 55/ Among other issues, the Commission sought to determine whether it "should adopt a schedule of disclosure items pursuant to Subsection 13(e) of the Exchange Act for issuers making tender offers for their own securities, including when issuers attempt to 'go private' and cease reporting under the Exchange Act." 56/

The Commission, in February 1975, proposed for consideration two alternative rules concerning going-private transactions. These alternatives, denominated Rules 13e-3A and 13e-3B, reflected a two-pronged approach: (1) a requirement that participants in a going-private transaction provide the company's shareholders with material information regarding the transaction; and (2) the adoption of substantive rules mandating, among other things, the fairness of the transaction to unaffiliated parties. 57/

54/(...continued)
Free Cash Flow and Stockholder Gains in Going Private Transactions 4-11 (December 21, 1988) (hereinafter "Lehn & Poulson").

55/ Public Fact-Finding Investigation in the Matter of Beneficial Ownership, Takeovers and Acquisitions by Foreign and Domestic Persons, Securities Act Release No. 5529 (September 9, 1974) [39 FR 33835].

56/ Id.

Section 13(e) of the Securities Exchange Act provides, in part, that the Commission may adopt rules and regulations to prescribe means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices in connection with a purchase by a Section 12 issuer or a purchase by an affiliate of such issuer of any equity security of such issuer. Section 13(e) was adopted as part of the Williams Act. Pub. L. No. 90-439, 82 Stat. 451 (1968).

57/ Securities Exchange Act Release No. 11231 (February 6, 1975) [40 FR 7947]. Both proposed rules would have imposed disclosure and fairness requirements. Proposed Rule 13e-3B in addition would have required that the transaction serve a legitimate business purpose.

On November 17, 1977, the Commission proposed for comment a new version of Rule 13e-3 58/ that combined disclosure with substantive and procedural safeguards. Among other things, the rule would have defined as a fraudulent, deceptive, or manipulative act any Rule 13e-3 transaction that was, among other things, unfair to unaffiliated security holders. The determination of the fairness of the transaction was to depend on the "facts and circumstances of each case."

Commentators were divided on the rule proposals, with many opposing substantive regulation as either unnecessary given the existing federal antifraud protection and the fairness requirements of state law, or as beyond the Commission's authority to adopt. 59/

On August 2, 1979, the Commission adopted Rule 13e-3, effective as of September 7, 1979. 60/ The Commission determined not to adopt a substantive fairness requirement in light of: the opposition by commentators; the Supreme Court's decision in Santa Fe Industries v. Green, 61/ restricting the reach of the Exchange Act's antifraud provisions to deceptive and manipulative conduct; and the potential administrative problems in terms of the staff resources and expertise necessary to implement such a rule. The Commission instead decided that it would leave the question

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58/ Securities Exchange Act Release No. 14185 (November 23, 1977) [42 FR 60090].

59/ *See* Summary of Comments Relating to Proposed Rules In the Matter of "Going Private" Transactions, File No. 4-178.

60/ *See* Securities Exchange Act Release No. 16075 (August 2, 1979) [44 FR 46748].

61/ 430 U.S. 462 (1977). The Court in Santa Fe ruled that a squeeze-out merger of minority shareholders did not violate Rule 10b-5 on the basis of alleged unfairness, where the terms of the transaction were fully disclosed. The Supreme Court recently has reiterated that the antifraud provisions do not proscribe unfair transactions, but it noted that the Commission's rulemaking authority under provisions like Section 13(e) extends beyond the prohibition of fraud to the adoption of prophylactic measures to deter fraud. Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 11 n.11 (1985).

of substantive fairness of going-private transactions to the states and limit itself to requiring certain disclosures. 62/

As discussed below, the rule seeks to provide shareholders with information they need to assess the fairness of a transaction and to pursue remedies under state law. There are some limitations on the reach of the rule that can be addressed initially by the Commission. In addition, state law has developed significantly since the adoption of the rule in providing shareholders with both substantive and procedural protection.

B. Operation of the Rule

Generally, Rule 13e-3, as adopted, requires that issuers and affiliates involved in going-private transactions to provide material information to the holders of the class of equity securities that is the subject of the transaction. Because a going-private transaction may be structured in a variety of forms, including a tender offer, merger agreement, or reverse stock split, the rule creates an independent filing obligation that supplements rather than replaces any other disclosure obligations that the federal securities laws impose as a result of the underlying transaction. In addition, the rule requires that the information be disseminated to holders of the subject securities at least 20 days prior to the consummation of the transaction.

The heart of the rule is the "Special Factors" requirements of Schedule 13E-3. (Rule 13e-3 and Schedule 13E-3 are attached as Appendix A.) Rather than impose a substantive fairness requirement, the Commission designed disclosure requirements to elicit sufficient information to allow shareholders to assess the fairness of the transaction for themselves and decide whether to participate or seek whatever remedy might be available under state law, including appraisal rights. Since the rule may be enforced privately, it provides a federal remedy should shareholders be misled or denied the mandated disclosure. 63/ The rule relies on the traditional disclosure approach of the federal securities laws to address the conflicts of interest that exist when management acts in both a proprietary role as a buyer (where its incentive is to pay the lowest possible price), and a

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62/ Securities Exchange Act Release No. 16075 (August 2, 1979) [44 FR 46748].

63/ Nationwide Corp. v. Howing Co., 826 F.2d 1470 (6th Cir. 1987), cert. denied, 105 S. Ct. 283 (1988) (action for damages).

representative capacity on behalf of the corporation and the shareholders (where its obligation is to obtain the highest possible price). The Commission, in promulgating Rule 13e-3, was cognizant of this conflict especially in terms of the potentially substantial informational advantage possessed by insiders and their ability to control the timing of such transactions. 64/

Items 7, 8 and 9 of Schedule 13E-3 are the Commission's disclosure alternative to a substantive fairness requirement. Together these disclosure items are designed to address management's informational advantages and allow shareholders to see the transaction through the eyes of management. Item 7 of the Schedule is designed to explore the reason why the issuer or its affiliate chose to engage in the going-private transaction. The item seeks to ascertain the purpose of the transaction, the alternatives that were considered, the reasons for the transaction's structure and timing, and the relative advantages and disadvantages to all parties -- the issuer, affiliate and unaffiliated shareholders.

Item 8 requires that the issuer and any affiliate engaged in the transaction state whether each reasonably believes that the transaction is fair to unaffiliated shareholders. In addition, the item requires that such party provide a reasonably detailed description of the factors upon which the issuer or affiliate based its fairness determination, including the analysis and conclusions with respect to each factor. In other words, while the rule does not require that a going-private transaction be "fair," the item is clearly "designed to assist security holders in making their investment decision by providing them with information from the most knowledgeable sources, regarding the terms and effects of the transaction in relation to the business and prospects of the issuer." 65/

The Commission recognized that, on occasion, matters relating to the fairness of the transaction that are not considered by the parties may be as significant as those that are specifically addressed. In construing the Item 8 disclosure requirements, the Commission has stated that "when a factor which would otherwise be important in determining the terms of the transaction is not considered or is given little weight because of the particular circumstances, this

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64/ See Securities Exchange Act Release No. 14185 (November 23, 1977) [42 FR 60090].

65/ Securities Exchange Act Release No. 17719, Question 21 (April 13, 1981) [46 FR 22571].

may be a significant aspect of the decision-making process which should be discussed in order to make the Item 8 disclosure understandable and complete." 66/ In this regard, Item 8 provides in an instruction a non-exclusive list of factors that ordinarily should be considered by a party making a fairness determination. 67/ These factors address the value of the company as a going concern, liquidation and breakup values, and values that might be obtained through an alternative transaction. In addition, if firm offers for the sale of all or part of the company have been received, those offers must be discussed. 68/ Thus, if management has engaged in a breakup analysis or explored asset sales, that information normally would be part of the Item 8 disclosure.

The structure of the item also reflects a recognition that the concept of fairness encompasses two components: fair price and procedural fairness. 69/ The item calls for disclosure concerning the existence of certain procedural safeguards "designed to enhance the protection of unaffiliated shareholders in the effectuation of the transaction." 70/ These safeguards include the receipt of an independent report, opinion, or appraisal, the need for approval by at least a majority of unaffiliated shareholders, the appointment of a committee of independent directors, and the retention of a financial adviser to negotiate on behalf of unaffiliated shareholders. Accordingly, an Item 8 discussion may need to include a "statement of the basis for the belief as to fairness despite the absence of these [procedural] safeguards." 71/

Lastly, Item 9 of the Schedule requires that the issuer or its affiliate state whether or not it has received any report, opinion, or appraisal from an outside party that is materially related to the Rule 13e-3 transaction. In addition, the item requires that the issuer, among other

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66/ Id.

67/ 17 CFR 240.13e-100, Item 8.

68/ 17 CFR 240.13e-100, Item 8(b), Instruction 1.

69/ See Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983). See also infra Section II.D.

70/ Securities Exchange Act Release No. 17719, Question 21 (April 13, 1981) [46 FR 22571].

71/ Id.

things, summarize and file as an exhibit any such report, opinion, or appraisal.

Typically, the report disclosed in an Item 9 discussion is that of a financial adviser. Rule 13e-3 does not mandate that such an opinion be received, only that, if it is received, the nature and limitations of the opinion be disclosed. Nor does it require that any such adviser retained to provide an opinion be independent. Rather, the item addresses concerns about the degree of reliance that should be placed on the opinion or report through disclosure of potential conflicts.

Item 9 was designed in recognition of the fact that the fairness opinion of a financial adviser often serves as a primary factor underpinning a board's fairness determination and that shareholders may accord substantial weight to the fact that a favorable opinion has been issued. 72/ Consequently, Item 9 requires detailed disclosure of the qualifications of the adviser rendering the decision, the terms of the engagement, potential conflicts of interest (including the manner of compensation), the procedures followed, and the bases for and methods of arriving at the findings contained in the opinion. 73/

The customary practice that has evolved in an MBO transaction is for an issuer (usually the board of directors or an independent committee of the board) to retain a financial adviser to evaluate the fairness of the transaction from a financial point of view. 74/ Generally, the financial adviser will perform a variety of tasks, depending on the terms of its engagement, including "shopping" the company, employing valuation techniques to ascertain the company's value, and opining upon whether a particular price is fair or unfair on the basis of publicly available information. Often, the adviser will rely solely on information provided by management without generating its own projections, cash flow analysis, or other analysis of the issuer's data. The

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72/ See generally Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 Yale L.J. 119 (1986) (hereinafter "Note").

73/ 17 CFR 240.13e-100, Item 9(b).

74/ See generally Simpson, The Emerging Role of the Special Committee - Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest, 43 Bus. Law. 665 (1988) (hereinafter "Simpson").

adequacy of the procedures used by the adviser bears on the degree to which directors will be credited with reasonable care under state law in determining whether they satisfied their fiduciary duties. 75/

The compensation arrangements for the financial adviser often depend on a variety of factors. Usually, the adviser will receive a base fee for rendering a fairness opinion. In some cases, the adviser may receive additional fees if the opinion is filed with the Commission. Moreover, the base fee or an additional fee may be contingent upon the outcome of the transaction or the actual value of the transaction.

It is not uncommon for a financial adviser to have a significant financial interest in the success of the transaction above and beyond the fee received for rendering the fairness opinion. For example, many financial advisers rendering opinions in the transaction also may arrange and/or provide financing for the transaction. In addition, if the adviser initiates the transaction or participates in asset sales, it may receive "broker" fees if the transaction is consummated.

The financial adviser customarily provides the issuer with a short-form opinion that restates the terms of its engagement, contains qualifying language as to the scope of the investigation undertaken, and opines as to the fairness of the transaction from a financial point of view. The opinion usually is preceded or augmented by an oral or written presentation made to the independent committee or full board of directors. In these presentations, the financial adviser generally outlines the valuation methodologies employed and the conclusions reached with respect to those techniques. If the adviser has determined a range of value for the company, this information usually will be provided to the directors. Item 9 requires that the financial adviser's supplemental written and oral presentations to the board describing its analyses be summarized in a reasonably detailed manner, and that any written report or opinion be filed as an exhibit to the schedule. 76/

Item 9 also requires the filing and disclosure of other reports provided to the issuer or affiliate engaged in the going-private transaction. The disclosure requirement is

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75/ *See infra* Section II.D.

76/ *See* Division of Corporation Finance No-Action Letter to Charles L. Ephraim (September 30, 1987).

construed to provide shareholders with substantially the same information received and considered by the board in approving the transaction. Thus, if the issuer or affiliate receives appraisals, projections, or cash flow analysis from an outside party, those reports would be required to be disclosed. In addition, any material nonpublic information in the possession of an affiliate engaged in the transaction, including projections and appraisals, will have to be disclosed to shareholders under general antifraud principles. 77/

C. Limitations of the Rule

1. Scope. Rule 13e-3 applies only to transactions engaged in by issuers and their affiliates. Transactions by third parties do not necessarily present the same concerns as MBOs because of the lack of a conflict of interest and potential informational advantages. In dealing with a third party bid, the management and board of directors presumably can be relied upon to represent the shareholders' interest. However, LBO practice has blurred the distinction between third-party LBOs and MBOs. In many transactions, purchasers have wanted existing management to remain with the company, and have offered incentives in the form of employment contracts and the opportunity to purchase an equity interest in the surviving company.

Where management's interest in the surviving company is sufficiently significant so as to render it an affiliate of the surviving company, management is deemed to be engaged in the transaction and is required to comply with Rule 13e-3 and file a Schedule 13E-3. However, in many instances no firm agreement or formal understandings with respect to the nature and extent of management's participation are reached prior to the completion of the transaction. Nonetheless, based upon prior transactions by the LBO firm and actual discussions, management may fully expect to participate in the surviving entity, even though the transaction technically falls outside the rule since it is being conducted solely by a third party. The staff has been examining the issues raised by these circumstances and is considering whether to recommend that the rule be revised to obtain the same level of disclosure as that mandated by Rule 13e-3 with respect to all negotiated transactions.

2. Valuation and Fairness Assessment. The "fairness assessment" does not assure that the price offered is the

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77/ See generally Chiarella v. United States, 445 U.S. 222 (1980).

best price that currently might be realizable by shareholders for their securities. There are examples of prices declared to be fair to shareholders that are quickly topped by 30-40 percent by a number of unsolicited bids; 78/ there also are examples of management making tremendous profits shortly after going private through sale of the company, asset divestitures, or bringing the company public again. 79/

The concept of fairness under state law historically has viewed fairness as a range and explicitly has recognized that a fair price is not necessarily the highest price currently obtainable. This historic view of fairness may reflect in part the inexact nature of modern valuation techniques and the difficulty in predicting the highest currently obtainable price, particularly in a highly active market environment. It is not clear whether recent case law suggesting a need for an auction may change this historic view and require fairness to reflect the best price obtainable for shareholders. 80/ Under the valuation theories applied to the fairness consideration, a fair price is "not the highest value attainable for the firm or a single value but a range of reasonable values." 81/ "[I]f the finest minds in corporate finance have tried to make business valuation a science, it remains an art." 82/ Given the limitations of the valuation techniques in predicting what price a company could obtain, it is not clear whether mandating that the transaction be determined to be fair, including the appointment of independent appraisers, would solve the problem. The Commission's staff will be reviewing these issues to determine whether the disclosure requirements of the rule can be revised to obtain better disclosure concerning the nature and limitations of fairness assessments. In this connection, the staff will consider whether it may be misleading for a company or affiliate to opine that a transaction is fair and purport to rely on an opinion when

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78/ See infra n.118.

79/ See supra n.51.

80/ See infra Section II.D.

81/ Note, supra n.72 at 124. See Chazen, Friedman & Feurstein, Premiums and Liquidation Values: Their Effects on the Fairness of an Acquisition, 11 Inst. On Sec. Reg. 147 (1980).

82/ Metz, "Deciding How Much a Company is Worth Often Depends on Whose Side You're On," Wall St. J., March 19, 1981, p. 29.

investment banking firm -- such as restrictions on the firm's ability to consider values obtained in recent comparable transactions, or reliance solely on the publicly available information. 83/ Questions have been raised about the adequacy of the fairness assessment when the company has not been shopped. 84/ Management may even carve out such common valuation techniques as liquidation value and comparable sale data on the ground they only intend to operate the entity as a going concern. The staff is exploring means of addressing concerns regarding the reasonableness of management's representations as to fairness. The reasonableness of such representations could turn on whether some minimal procedures and analyses were employed.

Nevertheless, as discussed below, federal law is not the sole source of shareholder protection with respect to MBOs. Recent experience has shown that state courts will entertain legal challenges to the fairness of going-private transactions and will provide shareholders with legal remedies. As indicated in the release adopting Rule 13e-3, the Commission continues to monitor developments in this area and the efficacy of the rule. The Commission vigorously enforces the existing disclosure requirements of the rule by improving disclosure through the informal staff comment process 85/ and, when necessary, by instituting enforcement actions. 86/

D. Relevant State Law Issues

As noted, federal law is not the sole source of shareholder protection with respect to MBOs. Indeed, issues

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83/ Cf. Securities Exchange Act Release No. 16833 (May 23, 1980) [45 FR 36374] (stating views of the staff that where valuation reports are so qualified and subject to material limitations and contingencies, inclusion of specific values in proxy materials may be unreasonable and violative of Rule 14a-9).

84/ See Longstreth, Management Buyouts: Are Public Shareholders Getting a Fair Deal, Remarks to the International Bar Ass'n. (October 6, 1983).

85/ For a discussion of the evolving nature of disclosure required by the Commission staff under Rule 13e-3, see Schunk & Willis, Leveraged Buyouts Wave of the Future, N.Y. Law Journal, Dec. 15, 1988, p. 39.

86/ See, e.g., In the Matter of Meyers Parking Systems, Inc., Exchange Act Release No. 26069 (September 12, 1988).

concerning substantive fairness to shareholders, which involve consideration of the obligations and fiduciary duties owed by management to shareholders, lie at the core of principles of corporate governance, the traditional province of state law. Since the adoption of Rule 13e-3, state law, especially the influential body of Delaware corporate law, has continued to evolve to address issues of fairness and management duties in the changing environment of takeovers and leveraged transactions. 87/

Under long-established principles of corporate law, a corporation's directors owe fiduciary duties, including duties of care and loyalty, to the company and to its shareholders. 88/ Ordinarily, courts will evaluate directors' actions under the business judgment rule, 89/ which is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." 90/ Under the rule, directors have broad discretion to make business decisions, but the rule is applicable only where the principles of care, loyalty, and independence are satisfied. 91/

87/ *See generally* DeMott, *Directors' Duties in Management Buyouts and Leveraged Recapitalizations*, Ohio St. L.J. 517 (1988); Gilson & Kraakman, *Delaware's Intermediate Standard For Defensive Tactics: Is There Substance To The Proportionality Review*?, John M. Olin Program in Law & Economics, Stanford Law School (Working Paper No. 45, August 1988) to be published in 44 Bus. Law (forthcoming February 1989 issue) (hereinafter "Gilson"); Morrissey, *Law, Ethics and the Leveraged Buyout*, 65 U. Det. L. Rev. 403 (1988); *Simpson*, *supra* n.74.

88/ *See*, *e.g.*, *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984); *Guth v. Loft*, 5 A.2d 503 (Del. 1939). In Delaware, these principles have been developed through case law. In other states, statutes define duties to which a director will be held. *See*, *e.g.*, Cal. Corp. Code 309(a) (West 1977 & Supp. 1987); N.Y. Bus. Corp. Law 717 (McKinney 1986 & Supp. 1988).

89/ For a summary of the business judgment rule, *see* Gilson, *supra* n.87.

90/ *Aronson v. Lewis*, 473 A.2d at 812.

91/ *Id.*; *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986).

In recent years, cases involving change of control transactions have evidenced increasingly vigilant judicial scrutiny of management conduct. This has occurred even in the absence of management participation in the change of control transaction. For example, in Smith v. Van Gorkum, 92/ the Delaware Supreme Court found directors of a corporation personally liable for a breach of their duty of care, where they approved a cash-out merger without taking adequate time to consider the transaction or receiving adequate information about the sufficiency of the offering price. In these circumstances, the court found that the directors did not "act in an informed and deliberate manner," as required by their fiduciary duty of care, and thus could not invoke the protections of the business judgment rule. 93/

Further, the Delaware Supreme Court has introduced a stricter standard for applying the business judgment rule to actions by directors in a change of control context. In Unocal Corp. v. Mesa Petroleum Co., 94/ the court noted that, as is the case in the performance of its other duties, when a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. However, the court stated that, "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred." 95/ Therefore, the court determined that the directors must show that "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed," and that the defensive measure was "reasonable in relation to the threat posed." 96/ Although the court in Unocal found the directors' decision -- a self-

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92/ 488 A.2d 858 (Del. 1985).

93/ Id. at 873. See also Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986) (directors failed to exercise due care in approving "lock-up" option, where they acted hastily and on inadequate information, and primarily relied on financial adviser's "conclusory" opinion that option prices were fair).

94/ 493 A.2d 946 (Del. 1985).

95/ Id. at 954.

96/ Id. at 955.

tender that excluded a hostile bidder -- to be reasonable, subsequent cases have enjoined other types of defensive tactics viewed to be unreasonable and unfair to shareholders. 97/ For example, the Delaware Chancery Court recently found that a board of directors' decision to keep the company's "poison pill" in place was not reasonable in relation to any threat posed by a pending third party tender offer, and therefore was not protected by the business judgment rule. 98/

It further has been recognized that, whether or not there is management participation in a change of control transaction, once the directors decide to put a company up for sale or it is clear that sale of the company has become inevitable, they must act as neutral auctioneers, whose primary responsibility is to realize the best sale price for the benefit of stockholders. 99/ To fulfill their duties, directors are prohibited from "playing favorites" with competing bidders "when the bidders make relatively similar offers or dissolution of the company becomes inevitable." 100/ Thus, once the "auction process" begins, courts will closely review the reasonableness of potentially

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97/ See, e.g., Robert M. Bass Group, Inc. v. Evans, [Current] Fed. Sec. L. Rep. (CCH) 93,924 (Del. Ch. July 14, 1988) (enjoining defensive restructuring that was found to be economically inferior to third-party bid and was to be adopted without shareholder approval); AC Acquisitions v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986) (enjoining partial self-tender because its structure precluded shareholders from accepting a competing hostile offer).

98/ Grand Metropolitan v. Pillsbury Co., [Current] Fed. Sec. L. Rep. (CCH) 94,104 (Del. Ch. Dec. 16, 1988).

99/ Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

100/ Id. at 184. See also Edelman v. Fruehauf, 798 F.2d 882, 887 (6th Cir. 1986) (relying on Revlon in enjoining target corporation's directors from using corporate funds and preempting bidding in order to assist corporation's management in effecting a leveraged buyout); Mills Acquisition Co. v. MacMillan Inc., [Current] Fed. Sec. L. Rep (CCH) 94,072 (Del. Nov. 2, 1988)(reversing the Chancery Court's denial of a preliminary injunction where the factual findings demonstrated that the bidding process was neither evenhanded nor neutral).

favoring tactics such as lock-up agreements 101/ and the exercise of "poison pill" rights. 102/ Moreover, the courts will determine independently whether sale of a company has become inevitable. 103/ As this case law develops, emphasis on the directors' responsibility to seek the best available price may overtake issues related to the fairness of valuations by management and its adviser.

Most importantly, where a transaction involves the potential for self-dealing, such as an MBO, courts have imposed even higher standards on directors' conduct. The Delaware Supreme Court has stated that where directors stand on both sides of a transaction, "they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain." 104/ In such cases, directors of Delaware corporations have the burden of establishing the transaction's "entire fairness" -- that is, the existence of both "fair dealing" and "fair price." 105/ Fair dealing relates to questions of procedural fairness, such as "when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained." 106/ Fair price relates to the consideration paid for a company's shares, "including all relevant factors: assets, market value, earnings, future prospects and any other elements that affect the intrinsic or inherent value of a company's stock." 107/

101/ See Edelman v. Freuhauf, 798 F.2d 882 (6th Cir. 1986); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A. 2d 173 (Del. 1986).

102/ See City Capital Associates Ltd. Partnership v. Interco, Inc., [Current] Fed. Sec. L. Rep. (CCH) 94,084 (Del. Ch. Nov. 1, 1988).

103/ See, e.g., Black & Decker Corp. v. American Standard Inc., 682 F. Supp. 772, 780-780 (D. Del. 1988); Robert M. Bass Group, Inc. v. Evans, [Current] Fed. Sec. L. Rep. (CCH) 93,924 (Del. Ch. July 14, 1988).

104/ Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

105/ Id. at 710-711.

106/ Id. at 711.

107/ Id.

In addition to emphasizing substantive and procedural fairness issues, Delaware courts have also been responsive to concerns about the need for adequate and timely shareholder remedies. Until recently, shareholders who dissented from cash-out mergers were limited to an "appraisal rights" remedy, a judicial determination of the fair value of their shareholdings under Section 262 of the Delaware Corporation Code. 108/ An appraisal value was traditionally assigned by determining the value of a shareholder's proportionate interest in the company, valued on a going-concern rather than a liquidated basis. However, the Delaware Supreme Court in Weinberger v. UOP, Inc. 109/ not only liberalized this process by permitting the use of all generally accepted techniques of valuation for determining fair value, but also recognized that an appraisal proceeding may be inadequate where there has been "fraud, misrepresentation, self dealing, deliberate waste of corporate assets, or gross and palpable overreaching." 110/ Accordingly, in these situations, shareholders are no longer limited to their statutory appraisal rights. Thus, in Cede & Co. v. Technicolor, Inc., 111/ the court upheld the right of a shareholder to pursue both an appraisal remedy and a subsequent action for rescissory damages based on a later-discovered claim of fraud in the merger. By recognizing the right of dissenting shareholders to bring a fraud action including fair dealing and fair price claims, the court assured the availability of whatever relief the facts of a particular case may require, including an injunction or damages. 112/

All of these legal developments have affected the context in which LBOs and MBOs take place. There is now stricter judicial review of actions in change of control

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108/ Del. Code Ann. tit. 8 262 (Supp. 1986).

109/ 457 A.2d 701 (Del. 1983).

110/ Id. at 714.

111/ 542 A.2d 1182 (Del. 1988).

112/ See id. at 1187. See also Rabkin v. Philip A. Hunt Chemical Corp., 498 A.2d 1099 (Del. 1985) (unfair dealing claims which raise issues appraisal cannot address are sufficient to defeat dismissal of an action to enjoin a proposed merger); Joseph v. Shell Oil Co., 498 A.2d 1117 (Del. Ch. 1985) (motion to dismiss injunction in favor of appraisal denied since it was uncertain that appraisal would provide an adequate remedy).

transactions, and more emphasis on safeguards designed to assure the fairness of such transactions. As a practical matter, the existence of a committee of independent directors to negotiate and evaluate a transaction appears especially important. 113/ Even the actions of disinterested directors will be examined to ensure that they acted fairly. 114/ Similarly, it is generally thought advisable for the independent committee to retain a financial adviser to evaluate the fairness of the transaction. While the courts have recognized that opinions as to reasonable value may differ, 115/ they will scrutinize the thoroughness and adequacy of the fairness analysis. 116/ If information is withheld from the financial adviser, or if the circumstances demonstrate that an opinion was hastily prepared or not based on careful analysis, the courts have not permitted the directors to rely on the opinion to justify the fairness of

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113/ See, e.g., Weinberger v. UOP, 457 A.2d at 709-710, n.7 (noting absence of independent committee). See also Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d at 272 (establishing an independent committee to negotiate with an LBO bidder that included management interest would have been appropriate); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 946 (proof of good faith and reasonable investigation when a threat of control is involved is materially enhanced by use of a committee of outside independent directors); Simpson, supra n.74 (business judgment rule protection is more likely to be available to decisions made through a committee of independent directors).

114/ See, e.g., Edelman v. Freuhauf Corp., 798 F.2d at 886 (authorization of transaction by disinterested directors not sufficient to establish its fairness where evidence indicates that these directors merely "rubber stamped" the management buyout proposal).

115/ See, e.g., Joseph v. Shell Oil Co., 482 A.2d at 347 (court well aware that expert appraisers usually express different opinions as to value even when they use the same data for arriving at opinion). See also Weinberger v. UOP, 457 A.2d at 712-714 (discussing various factors relevant to determination of fair price).

116/ In Dynamics Corp v. CTS Corp., 794 F.2d 250, 257 (7th Cir. 1988), rev'd on other grounds, 107 S. Ct 1637 (1987), the court discounted an investment banking firm's fairness opinion, where the firm was to have received a bonus if the takeover attempt was defeated.

their act. 117/ Moreover, once it is determined that a company is for sale, it is the directors' obligation to obtain the best price for shareholders through an auction process. Accordingly, the responsiveness of the courts to developments in the change of control area has promoted the use by corporate boards of extensive procedures and safeguards that result in greater substantive protections for shareholders. Indeed, recent change of control transactions reported by the press suggest that this heightened sensitivity has in fact resulted in higher values for shareholders. 118/

III. Other Concerns Arising Under the Federal Securities Laws

In addition to these concerns about the treatment of target shareholders of the target companies in leveraged transactions, there are concerns about other investors affected by such transactions, including: senior debtholders of the target company; investors in funds created by investment banks for equity participation in such transactions; purchasers of the so-called "junk bonds" issued to finance these transactions; and investors in institutions that are purchasers of large amounts of junk bonds. An important issue under the federal securities laws is whether all these participants receive full and fair disclosure about their investments.

One issue that has recently received much attention is the effect of leveraged transactions upon the market for the existing debt of an issuer. When an issuer creates large amounts of new debt through a leveraged buyout, thereby increasing its debt-to-equity ratio, it may also increase the risk of default. Consequently, the market may perceive the issuer's existing debt obligations as less creditworthy,

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117/ See, e.g., Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986) ("conclusory" opinion that price of lock-up option was "within the range of fair value," although adviser had not even calculated a range of fairness); Weinberger v. UOP, 457 A.2d 701 (Del. 1983) (hastily drafted fairness opinion); Joseph v. Shell Oil Co., 482 A.2d 335 (Del. Ch. 1984) (adviser who prepared fairness opinion was not given information about value of important company asset).

118/ The prevailing offer in the RJR transaction was 45% higher than that originally proposed to the board by the management group. See generally Gibson and Smith, "How Pillsbury Failed to Act Decisively in Bid to Repel Grand Met," Wall St. J., Dec. 19, 1988, p. A1 (table).

and the price of the issuer's bonds may decline. In some recent cases, there have been reports that, following announcement of leveraged transactions, the bond prices of the target companies experienced substantial declines. 119/ The risk that a bond will decline in value because of a leveraged transaction is known as "event risk."

Although current bond indentures include a variety of protective covenants, 120/ it appears that covenants in existing large investment grade issues have not generally provided for protection against event risk. Recent events demonstrate that the market may respond to this risk by requiring more protective covenants for senior debtholders in new issues. 121/ In particular, one development has been the creation of debt offerings containing so-called "poison puts," which provide that upon the occurrence of certain events, such as a major restructuring, the debtholder is granted the right to require the issuer to buy back the security at a specified price. If such covenants are effective, and if the company has the financial capability of meeting its obligations under the put, then bond purchasers in issues protected by such indenture provisions may be able to reduce the event risk associated with holding those debt instruments.

There have been questions about whether such covenants provide bondholders complete protection from certain types of restructurings. Many of these covenants have in the past, applied only to transactions not approved by the board, and thus would offer little protection against MBOs proposed by

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119/ Winkler, "Wall Street Is Devising the Takeover-Proof Bond," Wall St. J., Nov. 3, 1988, p. C1 (reporting 20% decline in some RJR Nabisco bonds); Wallace, "A Bruising Battle Over Bonds," N.Y. Times, Nov. 27, 1988, Sect. 3, p. 21 (prices of Federated Department Stores bonds fell 17% during its takeover battle with Campeau Corporation). *But see* Lehn & Poulsen, *supra* n.54.

120/ A bond contract is set forth in an indenture, which may contain covenants that restrain the issuer from taking certain actions that may harm the bondholder's interest. An indenture also is subject to the Trust Indenture Act of 1939, absent an exemption thereunder. 15 U.S.C. 77aaa *et seq*.

121/ Cox, "'Poison' Bonds May Get Higher Moody's Rating," Wall St. J., Nov. 21, 1988. p. C18; Lipin, "Agencies May Look to Covenants When Rating Debt," Investment Dealers' Digest, Nov. 14, 1988, p. 8.

management and approved by the board. 122/ A new generation of poison put provisions is, however, intended to provide greater protection to bond purchasers by protecting against "overleveraging" even if it has been approved by the issuer's board of directors. 123/ The Commission staff is monitoring all filings containing such covenants to see that the limitations in these provisions are adequately disclosed.

It should be noted that bondholders have argued that they have several legal remedies available to protect them from event risk. State law provides one potential avenue for relief. 124/ In addition, as discussed above, if an issuer

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122/ Herman, "How Bond Buyers Can Avoid an LBO Hit," Wall St. J., Oct. 24, 1988, p. C1.

123/ See supra n.119. Two variations of these new provisions have emerged. One type would allow bondholders to put back the debt security to the company in the event of any acquisition or recapitalization that results in the bond rating being downgraded. See Form S-3 filed by Harris Corp., Nov. 14, 1988. The other variation provides the issuer the option in such circumstances to redeem the bonds or adjust the interest rate upward to compensate for any loss of market value. See Form S-3 filed by Northwest Pipeline, Inc., Nov. 18, 1988.

124/ A Delaware court recently held that, "among the duties owed by directors of a Delaware corporation to holders of that corporation's debt instruments, there is no duty of the broad and exacting nature characterized as a fiduciary duty." Simons v. Cogan, 542 A.2d 785 (Del. Ch. 1987), aff'd, 549 A.2d 300 (Del. 1988). In reaching this conclusion, the court noted that debtholders can "turn to documents that exhaustively detail the rights and obligations of the issuer *** and of the holders of the securities. Such documents are typically carefully negotiated at arms-length. *** Accordingly, it is elementary that rights of bondholders are ordinarily fixed by and determinable from the language of documents that create and regulate the security." Id. at 786-87. Violations of statutes and fraud in the inducement can, however, create rights that are not articulated in the bond contract. Also, "in narrow circumstances," the contractual documents may be "held to imply obligations arising from an implied covenant of good faith and fair dealing." Id. at 787 (citing Katz v. Oak Industries, 508 A2.d 873, 878-80 (Del. Ch. 1986)); Continental Illionis National Bank and Trust Corp. v. Hunt

(continued...)

makes material misrepresentations or omissions in selling securities, it is subject to liability under the antifraud provisions of the federal securities laws, either in a Commission enforcement action or in a private action brought by purchasers of those securities. 125/ More generally, however, the Commission staff is considering the adequacy of disclosure currently provided to bondholders concerning matters such as the issuer's plans to engage in transactions that could affect the value of the bonds, and the potential risks involved if such transactions occur. The Commission staff will be considering whether additional disclosure concerning the effect of the transaction upon debtholders should be required in the context of leveraged change of control transactions.

A second category of investors involved in leveraged transactions are those who have invested in funds that provide equity participation in takeovers and leveraged buyouts. Many investment banks and other major participants in leveraged buyouts have raised funds from investors to create pools of assets, often in the form of limited partnerships, to use for the equity share in a leveraged

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124/(...continued)
International Resources Corp. C.A. No. 7888, (Feb. 27, 1987) (debenture holders have no independent right to maintain a claim for breach of fiduciary duty and their rights are defined by the terms of the indenture, absent fraud, insolvency, or a statutory violation). Moreover, state law theories of relief, such as theories based upon the law of fraudulent conveyances, may be available. See, e.g., McDaniel, Bondholders and Corporate Governance, 41 Bus. Law. 413 (1986). A private action against RJR Nabisco has been brought by bondholders alleging state law claims, including breach of contract, breach of duty, and fraudulent conveyance of property. Metropolitan Life Insurance Co. v. RJR Nabisco, Inc. and F. Ross Johnson, (N.Y. Sup. Ct.)

125/ Since the RJR Nabisco buyout announcement, private actions have been brought under the federal securities laws by bondholders, alleging that, in connection with a public offering of its bonds, the company misrepresented its future plans, and failed to disclose its consideration of a major restructuring transaction. Hartford Accident and Indemnity Co. and Hartford Fire Insurance Co. v. RJR Nabisco, Inc. (S.D.N.Y.); Gekoski v. Johnson, 88 Civ. 8636 (KTD) (S.D.N.Y.).

transaction. 126/ These funds are often created through unregistered private placements involving large institutional investors, such as pension funds, although some may be registered offerings. Typically, when the investment is made in such a fund, the investor does not know what transactions will be entered into by the fund. In some situations, this has led to controversy because investors have claimed that their fund has made a hostile bid although there was a commitment that the fund would engage in only friendly transactions. 127/

A third class of investors involved in leveraged buyouts consists of the purchasers of the debt issued to finance the LBO, the so-called "junk bonds." This category includes the purchasers in the initial placement of the bonds and subsequent purchasers in the secondary market. These investors are primarily institutional investors, who are attracted by the high rate of return. 128/ Individual investors also may indirectly participate in this market by investing in mutual funds that specialize or make significant investments in high-yield bonds. 129/ The offer or sale of high-yield bonds is subject to the same securities law requirements as the offer or sale of other securities. However, because of the complexity of the terms of the transaction and the possibility of higher risk, there may be heightened concerns about the adequacy of risk disclosure. For example, questions have been raised about illiquidity of the junk bond market. 130/ A further question is whether junk bond investors are being informed about the possible

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126/ Bartlett, "New Type of Owner Emerges in Wave of Company Buyouts," N.Y. Times, Nov. 8, 1988, p. A1.

127/ See White, "Cuomo Seeks Freeze in New York State Pension Fund's Investment in Buy-Outs," Wall St. J., Nov. 29, 1988, p. C21.

128/ Quint, "The Rapid Growth of 'Junk Bonds,'" N.Y. Times, Nov. 17, 1988, p. D1.

129/ Peers, "How to Take a 'Junk' Bond Plunge ...," Wall St. J., Nov. 15, 1988, p. C1.

130/ Farrell, "Junk Bonds Finally Face the Acid Test," Bus. Week, Nov. 16, 1987, p.64. In this regard, the staff has required disclosure in all registered debt offerings of whether the underwriter intends to make a secondary market in the securities, and if no decision has been made, the effect on market liquidity if the underwriter does not make a market.

need for future debt restructuring. Although such restructurings are typically exempt from registration pursuant to Section 3(a)(9) of the Securities Act, these transactions may raise questions about the adequacy of disclosure concerning additional risk of default, the reasons for the restructuring, or the issuer's alternative plans for avoiding default.

Finally, the need for adequate disclosure to investors in institutions that purchase large amounts of high-yield bonds or engage in lending in leveraged transactions, also must be considered. There has been considerable concern expressed recently that institutions such as banks, thrifts, or insurance companies may be concentrating their assets too heavily in LBO-related debt. 131/ Similarly, investment banks and broker-dealers provide bridge loan financing for LBOs. These financing arrangements can commit large amounts of capital from the firm's parent holding company or affiliate. 132/

131/ See, e.g., Taylor, "Agencies May Press Banks in Risky LBOs to Build Reserves, Raise Capital Levels," Wall St. J., Dec. 16, 1988, p. B2; Knight, "Regulators Worry About Risk in Financing of Big Takeovers," Wash. Post, Nov. 28, 1988, p. A1; Forde, "Analysts Study Effects of LBO Lending," Amer. Banker, Nov. 8, 1988, p. 2; Kilborn, "Borrowing Limits Urged by Greenspan," N.Y. Times. Oct. 27, 1988;

132/ A bridge loan is a form of temporary financing for a transaction in which an investment banker makes a loan to the target for a interim period until permanent financing can be arranged. On October 28, 1987, the Commission released two staff studies on bridge financings, describing specific transactions in which investment banks or their affiliates put their own capital at risk to facilitate acquisitions, and the structure of the affiliates used to do so. The studies discuss the Commission rules that require disclosure, prohibit manipulative activity in the securities markets, and require investment banks to have adequate net capital to conduct their businesses. See SEC News Release No. 87-77.

Subsequent to the release of those studies, and in response to a letter from the Commission addressing concerns about the conflicts of interests arising from the refinancing of bridge loans, the National Association of Securities Dealers amended its rules with

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Such commitments may limit the flexibility of the institution in other areas of its business, and expose the firm to additional risk in the event of rising interest rates or a recession. A particular concern in these situations is that the failure of a leveraged borrower can cause significant losses to these institutional creditors. Recent reports indicate that some large banks engaged in LBO lending syndicate a large percentage of their loans and retain only a small portion of the LBO loans they originate. 133/ Nevertheless, some banks do not sell substantial portions of their portfolio and there may be a period shortly after the loan transaction in which the lending risk is high because exposure has not been diversified. Investors in institutions engaged in LBO lending should be adequately informed about the institution's participation in such financing, the risks and potential exposure involved, and the effect on the institution's operations, if such matters are material. The Commission's staff is currently considering whether guidance should be issued concerning disclosure of holdings of financial instruments issued in connection with highly leveraged transactions.

Each of these situations has provoked considerable commentary, but the extent of the problems involved has not been closely examined. It is necessary to study these issues to determine the degree of any problem and the appropriate response. The Commission's Division of Corporation Finance is conducting a review of the level of current disclosure practice in these areas, and, if this review discovers inadequate or misleading disclosure, it will be necessary to consider whether enforcement actions, clarification of existing requirements, or additional disclosure requirements are necessary.

132/(...continued)
respect to underwritings of securities where a portion of the proceeds are intended for the underwriter (*i.e.*, underwritings used, at least in part, to repay a bridge loan). The NASD's rule amendment requires the appointment of an independent qualified underwriter to price the offering in bridge loan refinancings. *See* Securities Exchange Act Release No. 25629 (April 29, 1988) [53 FR 16207], amending Article III, Section 1 of the NASD's Rules of Fair Practice.

133/ Guenther, "Banks Offer Glimpse at LBO Portfolios, Showing that Many Loans are Re-sold," Wall St. J., Dec. 13, 1988, p. A3.

IV. Other Areas of Study

During the next few months, the Commission's Office of Economic Analysis (OEA) will gather data relevant to several issues concerning the economics of leveraged buyouts. In conducting the study, OEA has requested the cooperation of firms that specialize in arranging LBOs. It is hoped that the private data gathered from these firms can be combined with public data to provide information useful to Congress and to the Commission assessing the LBO phenomenon.

V. Conclusion

Leveraged buyouts raise several public policy issues. Management-led transactions present particularly difficult questions because of the potential for management abuse of its informational advantage over unaffiliated shareholders, as well as the conflicts of interest inherent in such transactions. The Commission has adopted an extensive and detailed disclosure scheme to address these issues and is constantly monitoring its effectiveness. In addition, state law has developed substantive and procedural protections for shareholders in these transactions. The Commission's staff will be exploring proposals to expand or modify the scope of current rules to assure that they address current market practice.

Other investor interests implicated by LBOs, including the interests of senior debt holders and the interests of investors who provide financing directly through investment funds or indirectly through banks, insurance funds, or other sources will also be carefully examined by the Commission. The Commission will further monitor developments under state law with respect to the rights of security holders, as well as the development of restrictive covenants to protect against the event risk that results from certain leveraged transactions. Finally, the staff will gather data on the LBO phenomenon in order to promote a full assessment by Congress and by the Commission of the policy implications of these transactions.

Table 1

NUMBER OF GOING PRIVATE TRANSACTIONS
AND EQUITY VALUE OF COMPANIES GOING PRIVATE,
1980-1988

Year	N	Pre-Transaction Average Equity Value (000)	Pre-Transaction Total Equity Value[1] (000)	Post-Transaction Total Equity Value[2] (000)	Percent Change in Total Equity Value
1980	17	$ 45,510	$ 773,676	$ 1,102,859	42.5%
1981	21	115,192	2,419,041	3,093,422	27.9%
1982	28	82,181	2,301,060	3,333,342	44.9%
1983	35	136,106	4,763,697	6,111,399	28.3%
1984	47	188,550	8,861,866	12,266,156	38.4%
1985	39	423,644	16,522,132	23,099,273	39.8%
1986	39	391,700	15,276,301	19,884,523	30.2%
1987	44	308,723	13,583,805	16,402,455	20.8%
1980-1987	270	238,895	64,501,578	85,293,428	32.2%
1980-1983	101	101,559	10,257,474	13,641,021	33.0%
1984-1987	169	320,971	54,244,104	71,652,407	32.1%
1988[3]	39	727,041	28,354,582	45,007,905	58.7%
Completed	32	367,314	11,754,038	18,147,985	54.4%
Pending	7	2,371,506	16,600,544	26,859,919[4]	61.8%
1980-1988	309	300,505	92,856,159	130,301,332	40.3%

[1] Computed as the price of common equity times the number of common shares outstanding, twenty trading days before the first announcement of the going private transaction.

[2] Computed as the price of the common equity on the last day that the common equity traded times the number of shares outstanding.

[3] 1988 data include only transactions of $100 million or more.

[4] Computed as closing price of common equity on January 20, 1989 times number of shares outstanding.

Source: SEC staff collected the sample of going private transactions by inspecting all corporate entries in annual editions of the Wall Street Journal Index, 1980-1987. Data on stock price data and number of shares outstanding were collected from Standard & Poor's Daily Stock Price Guides.

Dated:———.

————.
Signature.

————.
Name/Title.

The original statement shall be signed by each person on whose behalf the statement is filed or his authorized representative. If the statement is signed on behalf of a person by his authorized representative other than an executive officer or general partner of the filing person, evidence of the representative's authority to sign on behalf of such person shall be filed with the statement, *Provided, however,* That a power of attorney for this purpose which is already on file with the Commission may be incorporated by reference. The name and any title of each person who signs the statement shall be typed or printed beneath his signature.

NOTE: Six copies of this statement, including all exhibits, should be filed with the Commission.

ATTENTION: Intentional misstatements or omissions of fact constitute Federal criminal violations (see 18 U.S.C. 1001).

(Secs. 3(b), 13(d)(1), 13(d)(2), 13(d)(5), 13(d)(6), 13(g)(1), 13(g)(2), 13(g)(5), 23, 48 Stat. 882, 894, 901; sec. 203(a), 49 Stat. 704; sec. 8, 49 Stat. 1379; sec. 10, 78 Stat. 88a; sec. 2, 82 Stat. 454; secs. 1, 2, 84 Stat. 1497; secs. 3, 10, 18, 89 Stat. 97, 119, 155; secs. 202, 203, 91 Stat. 1494, 1498, 1499; (15 U.S.C. 78c(b), 78m(d)(1), 78m(d)(2), 78m(d)(5), 78m(d)(6), 78m(g)(1), 78m(g)(2), 78m(g)(5), 78w))

[43 FR 18499, Apr. 28, 1978, as amended at 43 FR 55756, Nov. 29, 1978; 44 FR 2148, Jan. 9, 1979; 44 FR 11751, Mar. 2, 1979]

§ 240.13e-1 Purchase of securities by issuer thereof.

When a person other than the issuer makes a tender offer for, or request or invitation for tenders of, any class of equity securities of an issuer subject to section 13(e) of the Act, and such person has filed a statement with the Commission pursuant to § 240.14d-1 and the issuer has received notice thereof, such issuer shall not thereafter, during the period such tender offer, request or invitation continues, purchase any equity securities of which it is the issuer unless it has complied with both of the following conditions:

(a) The issuer has filed with the Commission eight copies of a statement containing the information specified below with respect to the proposed purchases:

(1) The title and amount of securities to be purchased, the names of the persons or classes of persons from whom, and the market in which, the securities are to be purchased, including the name of any exchange on which the purchase is to be made;

(2) The purpose for which the purchase is to be made and whether the securities are to be retired, held in the treasury of the issuer or otherwise disposed of, indicating such disposition; and

(3) The source and amount of funds or other consideration used or to be used in making the purchases, and if any part of the purchase price or proposed purchase price is represented by funds or other consideration borrowed or otherwise obtained for the purpose of acquiring, holding, or trading the securities, a description of the transaction and the names of the parties thereto; and

(b) The initial statement shall be accompanied by a fee payable to the Commission as required by § 240.0-11.

(c) The issuer has at any time within the past 6 months sent or given to its equity security holders the substance of the information contained in the statement required by paragraph (a) of this section: *Provided, however,* That any issuer making such purchases which commenced prior to July 30, 1968 shall, if such purchases continue after such date, comply with the provisions of this rule on or before August 12, 1968.

[33 FR 14110, Sept. 18, 1968, as amended at 34 FR 6101, Apr. 4, 1969; 51 FR 2476, Jan. 17, 1986]

§ 240.13e-2 [Reserved]

§ 240.13e-3 Going private transactions by certain issuers or their affiliates.

(a) *Definitions.* Unless indicated otherwise or the context otherwise requires, all terms used in this section and in Schedule 13E-3 [§ 240.13e-100] shall have the same meaning as in the Act or elsewhere in the General Rules and Regulations thereunder. In addition, the following definitions apply:

(1) An "affiliate" of an issuer is a person that directly or indirectly through one or more intermediaries

controls, is controlled by, or is under common control with such issuer. For the purposes of this section only, a person who is not an affiliate of an issuer at the commencement of such person's tender offer for a class of equity securities of such issuer will not be deemed an affiliate of such issuer prior to the stated termination of such tender offer and any extensions thereof;

(2) The term "purchase" means any acquisition for value including, but not limited to, (i) any acquisition pursuant to the dissolution of an issuer subsequent to the sale or other disposition of substantially all the assets of such issuer to its affiliate, (ii) any acquisition pursuant to a merger, (iii) any acquisition of fractional interests in connection with a reverse stock split, and (iv) any acquisition subject to the control of an issuer or an affiliate of such issuer;

(3) A "Rule 13e-3 transaction" is any transaction or series of transactions involving one or more of the transactions described in paragraph (a)(3)(i) of this section which has either a reasonable likelihood or a purpose of producing, either directly or indirectly, any of the effects described in paragraph (a)(3)(ii) of this section;

(i) The transactions referred to in paragraph (a)(3) of this section are:

(A) A purchase of any equity security by the issuer of such security or by an affiliate of such issuer;

(B) A tender offer for or request or invitation for tenders of any equity security made by the issuer of such class of securities or by an affiliate of such issuer; or

(C) A solicitation subject to Regulation 14A [§§ 240.14a-1 to 240.14a-103] of any proxy, consent or authorization of, or a distribution subject to Regulation 14C [§§ 240.14c-1 to 14c-101] of information statements to, any equity security holder by the issuer of the class of securities or by an affiliate of such issuer, in connection with: a merger, consolidation, reclassification, recapitalization, reorganization or similar corporate transaction of an issuer or between an issuer (or its subsidiaries) and its affiliate; a sale of substantially all the assets of an issuer to its affiliate or group of affiliates; or a reverse stock split of any class of equity securities of the issuer involving the purchase of fractional interests.

(ii) The effects referred to in paragraph (a)(3) of this section are:

(A) Causing any class of equity securities of the issuer which is subject to section 12(g) or section 15(d) of the Act to be held of record by less than 300 persons; or

(B) Causing any class of equity securities of the issuer which is either listed on a national securities exchange or authorized to be quoted in an inter-dealer quotation system of a registered national securities association to be neither listed on any national securities exchange nor authorized to be quoted on an inter-dealer quotation system of any registered national securities association.

(4) An "unaffiliated security holder" is any security holder of an equity security subject to a Rule 13e-3 transaction who is not an affiliate of the issuer of such security.

(b) *Application of section to an issuer (or an affiliate of such issuer) subject to section 12 of the Act.* (1) It shall be a fraudulent, deceptive or manipulative act or practice, in connection with a Rule 13e-3 transaction, for an issuer which has a class of equity securities registered pursuant to section 12 of the Act or which is a closed-end investment company registered under the Investment Company Act of 1940, or an affiliate of such issuer, directly or indirectly

(i) To employ any device, scheme or artifice to defraud any person;

(ii) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(iii) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

(2) As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices in connection with any Rule 13e-3 transaction, it shall be unlawful for an issuer which has a class of equity securities registered pursuant to section 12 of

the Act, or an affiliate of such issuer, to engage, directly or indirectly, in a Rule 13e-3 transaction unless:

(i) Such issuer or affiliate complies with the requirements of paragraphs (d), (e) and (f) of this section; and

(ii) The Rule 13e-3 transaction is not in violation of paragraph (b)(1) of this section.

(c) *Application of section to an issuer (or an affiliate of such issuer) subject to section 15(d) of the Act.* (1) It shall be unlawful as a fraudulent, deceptive or manipulative act or practice for an issuer which is required to file periodic reports pursuant to Section 15(d) of the Act, or an affiliate of such issuer, to engage, directly or indirectly, in a Rule 13e-3 transaction unless such issuer or affiliate complies with the requirements of paragraphs (d), (e) and (f) of this section.

(2) An issuer or affiliate which is subject to paragraph (c)(1) of this section and which is soliciting proxies or distributing information statements in connection with a transaction described in paragraph (a)(3)(i)(A) of this section may elect to use the timing procedures for conducting a solicitation subject to Regulation 14A (§§ 240.14a-1 to 240.14a-103) or a distribution subject to Regulation 14C (§§ 240.14c-1 to 240.14c-101) in complying with paragraphs (d), (e) and (f) of this section, provided that if an election is made, such solicitation or distribution is conducted in accordance with the requirements of the respective regulations, including the filing of preliminary copies of soliciting materials or an information statement at the time specified in Regulation 14A or 14C, respectively.

(d) *Material required to be filed.* The issuer or affiliate engaging in a Rule 13e-3 transaction shall, in accordance with the General Instructions to the Rule 13e-3 Transaction Statement on Schedule 13E-3 [§ 240.13e-100]:

(1) File with the Commission eight copies of such schedule, including all exhibits thereto;

(2) Report any material change in the information set forth in such schedule by promptly filing with the Commission eight copies of an amendment on such schedule; and

(3) Report the results of the Rule 13e-3 transaction by filing with the Commission promptly but no later than ten days (ten business days if Rule 13e-4 [§ 240.13e-4] is applicable) after the termination of such transaction eight copies of a final amendment to such schedule.

(e) *Disclosure of certain information.* (1) The issuer or affiliate engaging in the Rule 13e-3 transaction, in addition to any other information required to be disclosed pursuant to any other applicable rule or regulation under the federal securities laws, shall disclose to security holders of the class of equity securities which is the subject of the transaction, in the manner prescribed by paragraph (f) of this section, the information required by Items 1, 2, 3, 4, 5, 6, 10, 11, 12, 13, 14, 15 and 16 of Schedule 13e-3 [§ 240.13e-100], or a fair and adequate summary thereof, and Items 7, 8 and 9 and include in the document which contains such information the exhibit required by Item 17(e) of such Schedule. If the Rule 13e-3 transaction involves (i) a transaction subject to Regulation 14A [§§ 240.14a-1 to 240.14a-103] or 14C [§§ 240.14c-1 to 240.14c-101] of the Act, (ii) the registration of securities pursuant to the Securities Act of 1933 and the General Rules and Regulations promulgated thereunder, or (iii) a tender offer subject to Regulation 14D [§§ 240.14d-1 to 240.14d-101] or Rule 13e-4 [§ 240.13e-4], such information shall be included in the proxy statement, the information statement, the registration statement or the tender offer for or request or invitation for tenders of securities published, sent or given to security holders, respectively.

(2) If any material change occurs in the information previously disclosed to security holders of the class of equity securities which is the subject of the transaction, the issuer or affiliate shall promptly disclose such change to such security holders in the manner prescribed by paragraph (f)(1)(iii) of this section.

(3) Any document transmitted to such security holders which contains the information required by paragraph (e)(1) of this section shall:

(i) Set forth prominently the information required by Items 7, 8 and 9 of the Rule 13e-3 Transaction Statement on Schedule 13E-3 [§ 240.13e-100] in a Special Factors section to be included in the forepart of such document; and

(ii) Set forth on the outside front cover page, in capital letters printed in bold face roman type at least as large as ten point modern type and at least two points leaded, the statement in paragraph (e)(3)(ii)(A) of this section, if the Rule 13e-3 transaction does not involve a prospectus, or the statement in paragraph (e)(3)(ii)(B) of this section, if the Rule 13e-3 transaction involves a prospectus, and in the latter case such statement shall be used in lieu of that required by Item 501(c)(5) of Regulation S-K (§ 229.501 of this chapter).

(A) THIS TRANSACTION HAS NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE FAIRNESS OR MERITS OF SUCH TRANSACTION NOR UPON THE ACCURACY OF ADEQUACY OF THE INFORMATION CONTAINED IN THIS DOCUMENT. ANY REPRESENTATION TO THE CONTRARY IS UNLAWFUL.

(B) NEITHER THIS TRANSACTION NOR THESE SECURITIES HAVE BEEN APPROVED OR DISARPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION. THE COMMISSION HAS NOT PASSED UPON THE FAIRNESS OR MERITS OF THIS TRANSACTION NOR UPON THE ACCURACY OR ADEQUACY OF THE INFORMATION CONTAINED IN THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS UNLAWFUL.

Instructions. 1. Negative responses to any item of Schedule 13E-3 [§ 240.13e-100] need not be included in the information disseminated to security holders unless otherwise indicated.

2. Although the financial information necessary to present a fair and adequate summary of Item 14 of Schedule 13E-3 [§ 240.13e-100] may vary depending on the facts and circumstances involved, the following historical and pro forma summary financial information normally will be sufficient for purposes of paragraph (e) of this section:

(a) The following summary financial information for (i) the two most recent fiscal years and (ii) the latest year-to-date interim period and corresponding interim period of the preceding year:

Income Statement:
Net sales and operating revenues and other revenues
Income before extraordinary items
Net Income
Balance Sheet (at end of period):
Working capital
Total assets
Total assets less deferred research and development charges and excess of cost of assets acquired over book value.
Shareholder's equity
Per Share:[1]
Income per common share before extraordinary items
Extraordinary items
Net income per common share (and common share equivalents, if applicable)
Net income per share on a fully diluted basis

(b) Ratio of earnings to fixed charges for the same periods required by 2(a) above;

(c) Book value per share as of the most recent fiscal year end and as of the date of the latest interim balance sheet; and

(d) If material, pro forma data for the summarized financial information described in 2(a), (b), and (c) above, disclosing the effect of the transaction, should be provided for the most recent fiscal year and latest year-to-date interim period.

If the information required by Item 14 is summarized, appropriate instructions should be included stating how more complete financial information can be obtained.

(f) *Dissemination of disclosure.* (1) If the Rule 13e-3 transaction involves a purchase as described in paragraph (a)(3)(i)(A) of this section or a vote, consent, authorization, or distribution of information statements as described in paragraph (a)(3)(i)(C) of this section, the issuer or affiliate engaging in the Rule 13e-3 transaction shall:

(i) Provide the information required by paragraph (e) of this section: (A) In accordance with the provisions of any applicable Federal or State law, but in no event later than 20 days prior to:

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[1] Average number of shares of common stock outstanding during each period was——(as adjusted to give effect to stock dividends or stock splits).

any such purchase; any such vote, consent or authorization; or with respect to the distribution of information statements, the meeting date, or if corporate action is to be taken by means of the written authorization or consent of security holders, the earliest date on which corporate action may be taken: *Provided, however,* That if the purchase subject to this section is pursuant to a tender offer excepted from Rule 13e-4 by paragraph (g)(5) of Rule 13e-4, the information required by paragraph (e) of this section shall be disseminated in accordance with paragraph (e) of Rule 13e-4 no later than 10 business days prior to any purchase pursuant to such tender offer, (B) to each person who is a record holder of a class of equity securities subject to the Rule 13e-3 transaction as of a date not more than 20 days prior to the date of dissemination of such information.

(ii) If the issuer or affiliate knows that securities of the class of securities subject to the Rule 13e-3 transaction are held of record by a broker, dealer, bank or voting trustee or their nominees, such issuer or affiliate shall (unless Rule 14a-3(d) [§ 240.14a-3(d)] or 14c-7 [§ 240.14c-7] is applicable) furnish the number of copies of the information required by paragraph (e) of this section that are requested by such persons (pursuant to inquiries by or on behalf of the issuer or affiliate), instruct such persons to forward such information to the beneficial owners of such securities in a timely manner and undertake to pay the reasonable expenses incurred by such persons in forwarding such information; and

(iii) Promptly disseminate disclosure of material changes to the information required by paragraph (d) of this section in a manner reasonably calculated to inform security holders.

(2) If the Rule 13e-3 transaction is a tender offer or a request or invitation for tenders of equity securities which is subject to Regulation 14D [§§ 240.14d-1 to 240.14d-101] or Rule 13e-4 [§ 240.13e-4], the tender offer containing the information required by paragraph (e) of this section, and any material change with respect thereto, shall be published, sent or given in accordance with Regulation 14D or Rule 13e-4, respectively, to security holders of the class of securities being sought by the issuer or affiliate.

(g) *Exceptions.* This section shall not apply to:

(1) Any Rule 13e-3 transaction by or on behalf of a person which occurs within one year of the date of termination of a tender offer in which such person was the bidder and became an affiliate of the issuer as a result of such tender offer: *Provided,* That the consideration offered to unaffiliated security holders in such Rule 13e-3 transaction is at least equal to the highest consideration offered during such tender offer and *Provided further,* That:

(i) If such tender offer was made for any or all securities of a class of the issuer;

(A) Such tender offer fully disclosed such person's intention to engage in a Rule 13e-3 transaction, the form and effect of such transaction and, to the extent known, the proposed terms thereof; and

(B) Such Rule 13e-3 transaction is substantially similar to that described in such tender offer; or

(ii) If such tender offer was made for less than all the securities of a class of the issuer:

(A) Such tender offer fully disclosed a plan of merger, a plan of liquidation or a similar binding agreement between such person and the issuer with respect to a Rule 13e-3 transaction; and

(B) Such Rule 13e-3 transaction occurs pursuant to the plan of merger, plan of liquidation or similar binding agreement disclosed in the bidder's tender offer.

(2) Any Rule 13e-3 transaction in which the security holders are offered or receive only an equity security *Provided,* That:

(i) Such equity security has substantially the same rights as the equity security which is the subject of the Rule 13e-3 transaction including, but not limited to, voting, dividends, redemption and liquidation rights except that this requirement shall be deemed to be satisfied if unaffiliated security holders are offered common stock;

(ii) Such equity security is registered pursuant to section 12 of the Act or reports are required to be filed by the issuer thereof pursuant to section 15(d) of the Act; and

(iii) If the security which is the subject of the Rule 13e-3 transaction was either listed on a national securities exchange or authorized to be quoted in an interdealer quotation system of a registered national securities association, such equity security is either listed on a national securities exchange or authorized to be quoted in an inter-dealer quotation system of a registered national securities association.

(3) Transactions by a holding company registered under the Public Utility Holding Company Act of 1935 in compliance with the provisions of that Act;

(4) Redemptions, calls or similar purchases of an equity security by an issuer pursuant to specific provisions set forth in the instrument(s) creating or governing that class of equity securities; or

(5) Any solicitation by an issuer with respect to a plan of reorganization under Chapter X of the Bankruptcy Act, as amended, if made after the entry of an order approving such plan pursuant to section 174 of that Act and after, or concurrently with, the transmittal of information concerning such plan as required by section 175 of the Act.

(Sec. 17(a), 19(a), 48 Stat. 84, 85; secs. 3(b), 10(b), 13(e), 14(a), 14(d), 14(e), 23(a), 48 Stat. 882, 894, 895, 891, 901; sec. 209, 48 Stat. 908; sec. 203(a), 49 Stat. 704; sec. 8, 49 Stat. 1379; sec. 10, 68 Stat. 686; sec. 5, 78 Stat. 569, 570; secs. 2, 3, 82 Stat. 454, 455; secs. 1, 2, 3-5, 84 Stat. 1497; secs. 3, 18, 89 Stat. 97, 155; 15 U.S.C. 77g(a), 77s(a), 78c(b), 78j(b), 78m(e), 78n(a), 78n(c), 78n(e), 78w(a); secs. 6, 7, 8, 10, 19(a), 48 Stat. 78, 79, 81, 85, secs. 205, 209, 48 Stat. 906, 908; sec. 301, 54 Stat. 857; sec. 8, 88 Stat. 685; sec. 1, 79 Stat. 1051; sec. 308(a)(2), 90 Stat. 57; secs. 12, 13, 14, 15(d), 23(a), 48 Stat. 892, 895, 901; secs. 1, 3, 8, 49 Stat. 1375, 1377, 1379; sec 203(a), 49 Stat. 704; sec. 202, 68 Stat. 686; secs. 3, 4, 5, 6, 78 Stat. 565–568, 569, 570–574; secs. 1, 2, 3, 82 Stat. 454, 455; secs. 28(c), "1, 2, 3-5, 84 Stat. 1435, 1497; sec. 105(b), 88 Stat. 1503; secs. 8, 9, 10, 18, 89 Stat. 117, 118, 119, 155; sec. 308(b), 90 Stat. 57; secs. 202, 203, 204, 81 Stat. 1494, 1498, 1499, 1500; 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a), 78l, 78m, 78n, 78o(d), 78w(a); secs. 3(b), 9(a)(6), 10(b), 13(e), 14(e) and 23(a) of the Act, 15 U.S.C. 78c(b), 78i(a), 78j(b), 78m(e), 78n(e) and 78w(a))

[44 FR 46741, Aug. 8, 1979, as amended at 47 FR 11466, Mar. 16, 1982; 48 FR 19877, May 3, 1983; 48 FR 34253, July 28, 1983]

§ 240.13e–4 Tender offers by issuers.

(a) *Definitions.* Unless the context otherwise requires, all terms used in this section and in Schedule 13E–4 [§ 240.13E-101] shall have the same meaning as in the Act or elsewhere in the General Rules and Regulations thereunder. In addition, the following definitions shall apply:

(1) The term "issuer" means any issuer which has a class of equity security registered pursuant to section 12 of the Act, or which is required to file periodic reports pursuant to section 15(d) of the Act, or which is a closed-end investment company registered under the Investment Company Act of 1940.

(2) The term "issuer tender offer" refers to a tender offer for, or a request or invitation for tenders of, any class of equity security, made by the issuer of such class of equity security or by an affiliate of such issuer.

(3) As used in this section and in Schedule 13E–4 [§ 240.13e-101], the term "business day" means any day, other than Saturday, Sunday, or a Federal holiday, and shall consist of the time period from 12:01 a.m. through 12:00 midnight Eastern Time. In computing any time period under this Rule or Schedule 13E–4, the date of the event that begins the running of such time period shall be included *except that* if such event occurs on other than a business day such period shall begin to run on and shall include the first business day thereafter.

(4) The term "commencement" means the date an issuer tender offer is first published, sent or given to security holders.

(5) The term "termination" means the date after which securities may not be tendered pursuant to an issuer tender offer.

(6) The term "security holders" means holders of record and beneficial owners of securities of the class of equity security which is the subject of an issuer tender offer.

(7) The term "security position listing" means, with respect to the securities of any issuer held by a registered

termination or withdrawal of the tender offer.

(6) Until the expiration of at least ten business days after the date of termination of the issuer tender offer, neither the issuer nor any affiliate shall make any purchases, otherwise than pursuant to the tender offer, of:

(i) Any security which is the subject of the issuer tender offer, or any security of the same class and series, or any right to purchase any such securities; and

(ii) In the case of an issuer tender offer which is an exchange offer, any security being offered pursuant to such exchange offer, or any security of the same class and series, or any right to purchase any such security.

(7) The time periods for the minimum offering periods and withdrawal rights pursuant to this section shall be computed on a concurrent, as opposed to a consecutive, basis.

(g) This section shall not apply to:

(1) Calls or redemptions of any security in accordance with the terms and conditions of its governing instruments;

(2) Offers to purchase securities evidenced by a scrip certificate, order form or similar document which represents a fractional interest in a share of stock or similar security;

(3) Offers to purchase securities pursuant to a statutory procedure for the purchase of dissenting security holders' securities;

(4) Any tender offer which is subject to section 14(d) of the *Act;*

(5) Offers to purchase from security holders who own an aggregate of not more than a specified number of shares that is less than one hundred: *Provided, however,* That the offer is made to all record and beneficial holders (other than participants in an issuer's plan, as that term is defined in Rule 10b-6(c)(4) under the Act [§ 240.10b-6(c)(4)], if the issuer elects not to extend the offer to such participants) who own that number of shares as of a specified date prior to the announcement of the offer; or

(6) Any other transaction or transactions, if the Commission, upon written request or upon its own motion, exempts such transaction or transactions, either unconditionally, or on specified terms and conditions, as not constituting a fraudulent, deceptive or manipulative act or practice comprehended within the purpose of this section.

(Secs. 3(b), 9(a)(6), 10(b), 13(e), 14(e), 15(c)(1), 23(a), 48 Stat. 882, 889, 891, 894, 895, 901, sec. 8, 49 Stat. 1379, sec. 5, 78 Stat. 569, 570, secs. 2, 3, 82 Stat. 454, 455, secs. 1, 2, 3–5, 84 Stat. 1497, secs. 3, 18, 89 Stat. 97, 155 (15 U.S.C. 78c(b), 78i(a), 78j(b), 78m(e), 78n(e), 78o(c), 78w(a)))

[44 FR 49410, Aug. 22, 1979, as amended at 47 FR 11467, Mar. 16, 1982; 47 FR 54780, Dec. 6, 1982; 48 FR 34253, July 28, 1983; 51 FR 3034, Jan. 23, 1986; 51 FR 5515, Feb. 14, 1986]

§ 240.13e–100 Schedule 13E–3 [§ 240.13e–3], Rule 13e–3 transaction statement pursuant to section 13(e) of the Securities Exchange Act of 1934 and rule 13e–3 [§ 240.13e–3] thereunder.

Securities and Exchange Commission,
Washington, D.C. 20549

Rule 13e–3 Transaction Statement

(Pursuant to Section 13(e) of the Securities Exchange Act of 1934)

[Amendment No.——]

____

(Name of the Issuer)

____

(Name of Person(s) Filing Statement)

____

(Title of Class of Securities)

____

(CUSIP Number of Class of Securities)

____

(Name, address and telephone number of person authorized to receive notices and communications on behalf of persons(s) filing statement)

This statement is filed in connection with (check the appropriate box):

a. ☐ The filing of solicitation materials or an information statement subject to Regulation 14A [17 CFR 240.14a-1 to 240.14a-103], Regulation 14C [17 CFR 240.14c-1 to 240.14c-101] or Rule 13e–3(c) [§ 240.13e–3(c)] under the Securities Exchange Act of 1934.

b. ☐ The filing of a registration statement under the Securities Act of 1933.

c. ☐ A tender offer.

d. ☐ None of the above.

Check the following box if the soliciting materials or information statement referred to in checking box (a) are preliminary copies: ☐

Instruction: Eight copies of this statement, including all exhibits, should be filed with the Commission.

CALCULATION OF FILING FEE

Transaction valuation*	Amount of filing fee

* Set forth the amount on which the filing fee is calculated and state how it was determined.

[ ] Check box if any part of the fee is offset as provided by Rule 0–11(a)(2) and identify the filing with which the offsetting fee was previously paid. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

Amount Previously Paid: __________
Form or Registration No.: __________
Filing Party: __________
Date Filed: __________

GENERAL INSTRUCTIONS

A. Depending on the type of Rule 13e-3 transaction, this statement shall be filed with the Commission:

1. Concurrently with the filing of "Preliminary Copies" of soliciting materials or an information statement pursuant to Regulations 14A or 14C under the Act;

2. Concurrently with the filing of a registration statement under the Securities Act of 1933;

3. As soon as practicable on the date a tender offer is first published, sent or given to security holders; or

4. At least 30 days prior to any purchase of any securities of the class of securities subject to the Rule 13e–3 transaction, if the transaction does not involve a solicitation, an information statement, the registration of securities or a tender offer, as described in 1, 2 or 3 of this Instruction.

5. If the Rule 13e–3 transaction involves a series of transactions, the issuer of affiliate shall file this statement at the time indicated in 1–4 of this general instruction for the first transaction of such series and shall promptly amend this schedule with respect to each subsequent transaction in such series.

B. The item numbers and captions of the items shall be included but the text of the items is to be omitted. The answers to the items shall be so prepared as to indicate clearly the coverage of the items without referring to the text of the items. Answer every item. If an item is inapplicable or the answer is in the negative, so state.

C. If the statement is filed by a general or limited-partnership, syndicate or other group the information called for by Items 2, 3, 5, 6, 10, and 11 shall be given with respect to: (i) Each partner of such general partnership; (ii) each partner who is denominated as a general partner or who functions as a general partner of such limited partnership; (iii) each member of such syndicate or group; and (iv) each person controlling such partner of member. If the statement is filed by a corporation or if a person referred to in (i), (ii), (iii) or (iv) of this Instruction is a corporation, the information called for by the above mentioned items shall be given with respect to: (a) Each executive officer and director of such corporation; (b) each person controlling such corporation; and (c) each executive officer and director of any corporation ultimately in control of such corporation.

D. Information contained in exhibits to the statement or in a filing by the issuer, other than filings the incorporation of which is governed by Instruction F, may be incorporated by reference in answer or partial answer to any item or sub-item of the statement, unless it would render such answer incomplete, unclear or confusing. Matter incorporated by reference pursuant to this Instruction shall be clearly identified in the reference by page, paragraph, caption or otherwise. Any express statement that the specified matter is incorporated by reference pursuant to this Instruction shall be made at the particular place in the statement where the information is required. A copy of any information or a copy of the pertinent pages of a document containing such information which is incorporated by reference shall be submitted with this statement as an exhibit and shall be deemed to be filed with the Commission for all purposes of the Act.

E. The information required by the items of this statement is intended to be in addition to any disclosure requirements of any other form or schedule which may be filed with the Commission in connection with the Rule 13e–3 transaction. To the extent that the disclosure requirements of this statement are inconsistent with the disclosure requirements of any such forms or schedules, the requirements of this statement are controlling.

F. If the Rule 13e–3 transaction involves a transaction subject to Regulation 14A [§§ 240.14a–1 to 240.14a–103] or 14C [§§ 240.14c–1 to 240.14c–101] of the Act, the registration of securities pursuant to the Securities Act of 1933 and the General Rules and Regulations promulgated thereunder, or a tender offer subject to Regulation 14D [§§ 240.14d–1 to 240.14d–101] or Rule 13e–4 [§ 240.13e–4], the information contained in the proxy or information statement, the registration statement, the Schedule 14D–1 [§ 240.14d–100], or the Schedule 13E–4, respectively, which is filed with the Commission shall be incorporated by reference in answer to the items of this statement or amendments thereto; this statement shall include an express statement to that effect and a cross reference sheet showing the location in the proxy or information statement, the registration statement, the Schedule 14D-1 or the Schedule 13E-4 of the information required to be included in response to the items of this statement. If any such item is inapplicable or the answer thereto is in the negative and is omitted from the proxy or the information statement, the registration statement, the Schedule 14D-1, or the Schedule 13E-4, a statement to that effect shall be made in the cross reference sheet.

G. If the Rule 13e-3 transaction involves a proxy or an information statement subject to Regulation 14A [§§ 240.14a-1 to 240.14a-103] or Regulation 14C [§§ 240.14c-1 to 14c-101] and if preliminary copies of such materials have been incorporated by reference into this statement pursuant to Instruction F of this statement, this Schedule 13E-3 shall be deemed to constitute "Preliminary Copies" within the meaning of Rule 14a-6(e) [§ 240.14a-6] and Rule 14c-5 [§ 240.14c-5] and shall not be available for public inspection before an amendment to this statement containing definitive material has been filed with the Commission.

H. Amendments disclosing a material change in the information set forth in this statement may omit any information previously disclosed in this statement.

Item 1. Issuer and Class of Security Subject to the Transaction. (a) State the name of the issuer of the class of equity security which is the subject of the Rule 13e-3 transaction and the address of its principal executive offices.

(b) State the exact title, the amount of securities outstanding of the class of security which is the subject of the Rule 13e-3 transaction as of the most recent practicable date and the approximate number of holders of record of such class as of the most recent practicable date.

(c) Identify the principal market in which such securities are being traded and, if the principal market is an exchange, state the high and low sales prices for such securities as reported in the consolidated transaction reporting system or, if not so reported, on such principal exchange for each quarterly period during the past two years. If the principal market is not an exchange, state the range of high and low bid quotations for each quarterly period during the past two years, the source of such quotations and, if there is currently no established trading market for such securities (excluding limited or sporadic quotations), furnish a statement to that effect.

(d) State the frequency and amount of any dividends paid during the past two years with respect to such class of securities and briefly describe any restriction on the issuer's present or future ability to pay such dividends.

Instruction: If the person filing this statement is an affiliate of the issuer, the information required by Item 1(d) should be furnished to the extent known by such affiliate after making reasonable inquiry.

(e) If the issuer and/or affiliate filing this statement has made an underwritten public offering of such securities for cash during the past three years which was registered under the Securities Act of 1933 or exempt from registration thereunder pursuant to Regulation A, state the date of such offering, the amount of securities offered, the offering price per share (which should be appropriately adjusted for stock splits, stock dividends, etc.) and the aggregate proceeds received by such issuer and/or such affiliate.

(f) With respect to any purchases of such securities made by the issuer or affiliate since the commencement of the issuer's second full fiscal year preceding the date of this schedule, state the amount of such securities purchased, the range of prices paid for such securities and the average purchase price for each quarterly period of the issuer during such period.

Instruction: The information required by Item 1(f) need not be given with respect to purchases of such securities by a person prior to the time such person became an affiliate.

Item 2. Identity and Background. If the person filing this statement is the issuer of the class of equity securities which is the subject of the Rule 13e-3 transaction, make a statement to that effect. If that statement is being filed by an affiliate of the issuer which is other than a natural person or if any person enumerated in Instruction C to this statement is a corporation, general partnership, limited partnership, syndicate or other group of persons, state its name, the state or other place of its organization, its principal business, the address of its principal executive offices and provide the information required by (e) and (f) of this Item. If this statement is being filed by an affiliate of the issuer who is a natural person or if any person enumerated in Instruction C of this statement is a natural person, provide the information required by (a) through (g) of this Item with respect to such person(s).

(a) Name;

(b) Residence or business address;

(c) Present principal occupation or employment and the name, principal business and address of any corporation or other organization in which such employment or occupation is conducted;

(d) Material occupations, positions, offices or employments during the last 5 years, giving the starting and ending dates of each and the name, principal business and address of any business corporation or other organization in which such occupation, position, office or employment was carried on;

(e) Whether or not, during the last 5 years, such person has been convicted in a criminal proceeding (excluding traffic violations or similar misdemeanors) and, if so, give the dates, nature of conviction, name and location of court, and penalty imposed or other disposition of the case;

(f) Whether or not, during the last 5 years, such person was a party to a civil proceeding of a judicial or administrative body of competent jurisdiction and as a result of such proceeding was or is subject to a judgment, decree or final order enjoining further violations of, or prohibiting activities subject to, federal or state securities laws or finding any violation of such laws; and, if so, identify and describe such proceeding and summarize the terms of such judgment, decree or final order;

Instruction: While negative answers to Items 2(e) and 2(f) are required in this schedule, they need not be furnished to security holders.

(g) Citizenship(s).

Item 3. Past Contacts, Transactions or Negotiations. (a) If this schedule is filed by an affiliate of the issuer of the class of securities which is the subject of the Rule 13e-3 transaction:

(1) Briefly state the nature and approximate amount (in dollars) of any transaction, other than those described in Item 3(b) of this schedule, which has occurred since the commencement of the issuer's second full fiscal year preceding the date of this schedule between such affiliate (including subsidiaries of the affiliate and those persons enumerated in Instruction C of this schedule) and the issuer: *Provided, however,* That no disclosure need be made with respect to any transaction if the aggregate amount involved in such transaction was less than one percent of the issuer's consolidated revenues (which may be based upon information contained in the most recently available filing with the Commission by the issuer unless such affiliate has reason to believe otherwise) (i) for the fiscal year in which such transaction occurred or (ii) for the portion of the current fiscal year which has occurred, if the transaction occurred in such year; and

(2) Describe any contacts, negotiations or transactions which have been entered into or which have occurred since the commencement of the issuer's second full fiscal year preceeding the date of this schedule between such affiliate (including subsidiaries of the affiliate and those persons enumerated in Instruction C of this schedule) and the issuer concerning: a merger, consolidation or acquisition; a tender offer for or other acquisition of securities of any class of the issuer; an election of directors of the issuer; or a sale or other transfer of a material amount of assets of the issuer or any of its subsidiaries.

(b) Describe any contacts or negotiations concerning the matters referred to in Item 3(a)(2) which have been entered into or which have occurred since the commencement of the issuer's second full fiscal year precding the date of this schedule (i) between any affiliates of the issuer of the class of securities which is the subject of the Rule 13e-3 transaction; or (ii) between such issuer or any of its affiliates and any person who is not affiliated with the issuer and who would have a direct interest in such matters. Identify the person who initiated such contacts or negotiations.

Item 4. Terms of the Transaction. (a) State the material terms of the Rule 13e-3 transaction.

(b) Describe any term or arrangement concerning the Rule 13e-3 transaction relating to any security holder of the issuer which is not identical to that relating to other security holders of the same class of securities of the issuer.

Item 5. Plans or Proposals of the Issuer or Affiliate. Describe any plan or proposal of the issuer or affiliate regarding activities or transactions which are to occur after the Rule 13e-3 transaction which relate to or would result in: (a) An extraordinary corporate transaction, such as a merger, reorganization or liquidation, involving the issuer or any of its subsidiaries;

(b) A sale or transfer of a material amount of assets of the issuer or any of its subsidiaries;

(c) Any change in the present board of directors or management of the issuer including, but not limited to, any plan or proposal to change the number or term of directors, to fill any existing vacancy on the board or to change any material term of the employment contract of any executive officer;

(d) Any material change in the present dividend rate or policy or indebtedness or capitalization of the issuer;

(e) Any other material change in the issuer's corporate structure or business;

(f) A class of equity securities of the issuer becoming eligible for termination of registration pursuant to section 12(g)(4) of the Act; or

(g) The suspension of the issuer's obligation to file reports pursuant to section 15(d) of the Act.

Item 6. Source and Amounts of Funds or Other Consideration. (a) State the source and total amount of funds or other consideration to be used in the Rule 13e-3 transaction.

(b) Furnish a reasonably itemized statement of all expenses incurred or estimated to be incurred in connection with the Rule 13e-3 transaction including, but not limited to, filing fees, legal, accounting and appraisal fees, solicitation expenses and printing costs and state whether or not the issuer has paid or will be responsible for paying any or all of such expenses.

(c) If all or any part of such funds or other consideration is, or is expected to be, directly or indirectly borrowed for the purpose of the Rule 13e–3 transaction,

(1) Provide a summary of each such loan agreement containing the indentity of the parties, the term, the collateral, the stated and effective interest rates, and other material terms or conditions; and

(2) Briefly describe any plans or arrangements to finance or repay such borrowings, or, if no such plans or arrangements have been made, make a statement to that effect.

(d) If the source of all or any part of the funds to be used in the Rule 13e–3 transaction is a loan made in the ordinary course of business by a bank as defined by section 3(a)(6) of the Act and section 13(d) or 14(d) is applicable to such transaction, the name of such bank shall not be made available to the public if the person filing the statement so requests in writing and files such request, naming such bank, with the Secretary of the Commission.

Item 7. Purpose(s), Alternatives, Reasons and Effects. (a) State the purpose(s) for the Rule 13e–3 transaction.

(b) If the issuer or affiliate considered alternative means to accomplish such purpose(s), briefly describe such alternative(s) and state the reason(s) for their rejection.

(c) State the reasons for the structure of the Rule 13e–3 transaction and for undertaking such transaction at this time.

(d) Describe the effects of the Rule 13e–3 transaction on the issuer, its affiliates and unaffiliated security holders, including the federal tax consequences.

Instructions: (1) Conclusory statements will not be considered sufficient disclosure in response to Item 7.

(2) The description required by Item 7(d) should include a reasonably detailed discussion of the benefits and detriments of the Rule 13e–3 transaction to the issuer, its affiliates and unaffiliated security holders. The benefits and detriments of the Rule 13e–3 transaction should be quantified to the extent practicable.

(3) If this statement is filed by an affiliate of the issuer, the description required by Item 7(d) should include but not be limited to, the effect of the Rule 13e–3 transaction on the affiliate's interest in the net book value and net earnings of the issuer in terms of both dollar amounts and percentages.

Item 8. Fairness of the Transaction. (a) State whether the issuer or affiliate filing this schedule reasonably believes that the Rule 13e–3 transaction is fair or unfair to unaffiliated security holders. If any director dissented to or abstained from voting on the Rule 13e–3 transaction, identify each such director, and indicate, if known, after making reasonable inquiry, the reasons for each dissent or abstention.

Instruction. A statement that the issuer or affiliate has no reasonable belief as to the fairness of the Rule 13e–3 transaction to unaffiliated security holders will not be considered sufficient disclosure in response to Item 8(a).

(b) Discuss in reasonable detail the material factors upon which the belief stated in Item 8(a) is based and, to the extent practicable, the weight assigned to each such factor. Such discussion should include an analysis of the extent, if any, to which such belief is based on the factors set forth in instruction (1) to paragraph (b) of this Item, paragraphs (c), (d), and (e) of this Item, and Item 9.

Instructions. (1) The factors which are important in determining the fairness of a transaction to unaffiliated security holders and the weight, if any, which should be given to them in a particular context will vary. Normally such factors will include, among others, those referred to in paragraphs (c), (d) and (e) of this Item and whether the consideration offered to unaffiliated security holders constitutes fair value in relation to:

(i) Current market prices,

(ii) Historical market prices,

(iii) Net book value,

(iv) Going concern value,

(v) Liquidation value,

(vi) The purchase price paid in previous purchases disclosed in Item 1(f) of Schedule 13e–3,

(vii) Any report, opinion, or appraisal described in Item 9 and

(viii) Firm offers of which the issuer or affiliate is aware made by any unaffiliated person, other than the person filing this statement, during the preceding eighteen months for:

(A) The merger or consolidation of the issuer into or with such person or of such person into or with the issuer,

(B) The sale or other transfer of all or any substantial part of the assets of the issuer or

(C) Securities of the issuer which would enable the holder thereof to exercise control of the issuer.

(2) Conclusory statements, such as "The Rule 13e–3 transaction is fair to unaffiliated security holders in relation to net book value, going concern value and future prospects of the issuer" will not be considered sufficient disclosure in response to Item 8(b).

(c) State whether the transaction is structured so that approval of at least a majority of unaffiliated security holders is required.

(d) State whether a majority of directors who are not employees of the issuer has retained an unaffiliated representative to act solely on behalf of unaffiliated security holders for the purposes of negotiating the terms of the Rule 13e-3 transaction and/or preparing a report concerning the fairness of such transaction.

(e) State whether the Rule 13e-3 transaction was approved by a majority of the directors of the issuer who are not employees of the issuer.

(f) If any offer of the type described in instruction (vii) to Item 8(b) has been received, describe such offer and state the reason(s) for its rejection.

Item 9. Reports, Opinions, Appraisals and Certain Negotiations. (a) State whether or not the issuer or affiliate has received any report, opinion (other than an opinion of counsel) or appraisal from an outside party which is materially related to the Rule 13e-3 transaction including, but not limited to, any such report, opinion or appraisal relating to the consideration or the fairness of the consideration to be offered to security holders of the class of securities which is the subject of the Rule 13e-3 transaction or the fairness of such transaction to the issuer or affiliate or to security holders who are not affiliates.

(b) With respect to any report, opinion or appraisal described in Item 9(a) or with respect to any negotiation or report described in Item 8(d) concerning the terms of the Rule 13e-3 transaction:

(1) Identify such outside party and/or unaffiliated representative;

(2) Briefly describe the qualifications of such outside party and/or unaffiliated representative;

(3) Describe the method of selection of such outside party and/or unaffiliated representative;

(4) Describe any material relationship between (i) the outside party, its affiliates, and/or unaffiliated representative, and (ii) the issuer or its affiliates, which existed during the past two years or is mutually understood to be contemplated and any compensation received or to be received as a result of such relationship;

(5) If such report, opinion or appraisal relates to the fairness of the consideration, state whether the issuer or affiliate determined the amount of consideration to be paid or whether the outside party recommended the amount of consideration to be paid.

(6) Furnish a summary concerning such negotiation report, opinion or appraisal which shall include, but not be limited to, the procedures followed; the findings and recommendations; the bases for and methods of arriving at such findings and recommendations; instructions received from the issuer or affiliate; and any limitation imposed by the issuer or affiliate on the scope of the investigation.

Instruction: The information called for by subitem 9(b)(1), (2) and (3) should be given with respect to the firm which provides the report, opinion or appraisal rather than the employees of such firm who prepared it.

(c) Furnish a statement to the effect that such report, opinion or appraisal shall be made available for inspection and copying at the principal executive offices of the issuer or affiliate during its regular business hours by any interested equity security holder of the issuer or his representative who has been so designated in writing. This statement may also provide that a copy of such report, opinion or appraisal will be transmitted by the issuer or affiliate to any interested equity security holder of the issuer or his representative who has been so designated in writing upon written request and at the expense of the requesting security holder.

Item 10. Interest in Securities of the Issuer. (a) With respect to the class of equity security to which the Rule 13e-3 transaction relates, state the aggregate amount and percentage of securities beneficially owned (identifying those securities for which there is a right to acquire) as of the most recent practicable date by the person filing this statement (unless such person is the issuer), by any pension, profit sharing or similar plan of the issuer or affiliate, by each person enumerated in Instruction C of this Schedule or by any associate or majority owned subsidiary of the issuer or affiliate giving the name and address of any such associate or subsidiary.

Instructions: 1. For the purpose of this Item, beneficial ownership shall be determined in accordance with Rule 13e-3 [17 CFR 240.13d-3] under the Exchange Act.

2. The information required by this paragraph should be given with respect to officers, directors and associates of the issuer to the extent known after making reasonable inquiry.

(b) Describe any transaction in the class of equity securities of the issuer which is the subject of a Rule 13e-3 transaction that was effected during the past 60 days by the issuer of such class or by the persons named in response to paragraph (a) of this Item.

Instructions: 1. The description of a transaction required by Item 10(b) shall include, but not necessarily be limited to: (i) the identity of the person covered by Item 10(b) who effected the transaction; (ii) the date of the transaction; (iii) the amount of securities involved; (iv) the price per security; and (v) where and how the transaction was effected.

2. If the information required by Item 10(b) is available to the person filing this statement at the time this statement is initially filed with the Commission, the information shall be included in the initial filing.

However, if the information is not available to such person at the time of such initial filing, it shall be filed with the Commission promptly but in no event later than seven days (or 2 business days with respect to a tender subject to Regulation 14D [§§ 240.14d-1 to 240.14d-101] or 10 business days with respect to a tender offer subject to Rule 13e-4 [§ 240.13e-4]) after the date of such filing and, if material, disclosed to security holders of the issuer pursuant to Rule 13e-3(e) [§ 240.13e-3(e)], and disseminated to them in a manner reasonably calculated to inform security holders.

Item 11. Contracts, Arrangements or Understandings with Respect to the Issuer's Securities. Describe any contract, arrangement, understanding or relationship (whether or not legally enforceable) in connection with the Rule 13e-3 transaction between the person filing this statement (including any person enumerated in Instruction C of this schedule) and any person with respect to any securities of the issuer (including, but not limited to, any contract, arrangement, understanding or relationship concerning the transfer or the voting of any such of such securities, joint ventures, loan or option arrangements, puts or calls, guaranties of loans, guaranties against loss or the giving or withholding proxies, consents or authorizations), naming the persons with whom such contracts, arrangements, understandings or relationships have been entered into and giving the material provisions thereof. Include such information for any of such securities that are pledged or otherwise subject to a contingency, the occurrence of which would give another person the power to direct the voting or disposition of such securities, except that disclosure of standard default and similar provisions contained in loan agreements need not be included.

Item 12. Present Intention and Recommendation of Certain Persons with Regard to the Transaction. (a) To the extent known by the person filing this statement after making reasonable inquiry, furnish a statement of present intention with regard to the Rule 13e-3 transaction indicating whether or not any executive officer, director or affiliate of the issuer or any person enumerated in Instruction C of this statement will tender or sell securities of the issuer owned or held by such person and/or how such securities, and securities with respect to which such person holds proxies, will be voted and the reasons therefor.

Instruction: If the information required by Item 12(a) is available to the person filing this statement at the time this statement is initially filed with the Commission, the information shall be included in the initial filing. However, if the information is not available to such person at the time of such initial filing, it shall be filed with the Commission promptly but in no event later than seven days (or two business days with respect to a tender offer subject to Regulation 14D [§ 240.14d-1 to 240.14d-101] or ten business days with respect to a tender offer subject to Rule 13e-4 [§§ 240.13e-4]) after the date of such filing and, if material, disclosed to security holders of the issuer pursuant to Rule 13e-3(e) [§ 240.13e-3(e)], and disseminated to them in a manner reasonably calculated to inform security holders.

(b) To the extent known by the person filing this statement after making reasonable inquiry, state whether any person named in paragraph (a) of this item has made a recommendation in support of or opposed to the Rule 13e-3 transaction and the reasons for such recommendation. If no recommendation has been made by such persons, furnish a statement to that effect.

Item 13. Other Provisions of the Transaction. (a) State whether or not appraisal rights are provided under applicable state law or under the issuer's articles of incorporation or will be voluntarily accorded by the issuer or affiliate to security holders in connection with the Rule 13e-3 transaction and, if so, summarize such appraisal rights. If appraisal rights will not be available under the applicable state law, to security holders who object to the transaction, briefly outline the rights which may be available to such security holders under such law.

(b) If any provision has been made by the issuer or affiliate in connection with the Rule 13e-3 transaction to allow unaffiliated security holders to obtain access to the corporate files of the issuer or affiliate or to obtain counsel or appraisal services at the expense of the issuer or affiliate, describe such provision.

(c) If the Rule 13e-3 transaction involves the exchange of debt securities of the issuer or affiliate for the equity securities held by security holders of the issuer who are not affiliates, describe whether or not the issuer or affiliate will take steps to provide or assure that such securities are or will be eligible for trading on any national securities exchange or an automated inter-dealer quotation system.

Item 14. Financial Information. (a) Furnish the following financial data concerning the issuer: (1) Audited financial statements for the two fiscal years required to be filed with the issuer's most recent annual report under sections 13 and 15(d) of the Act;

(2) Unaudited balance sheets and comparative year-to-date income statements and statements of changes in financial position and related earnings per share amounts required to be included in the issuer's most recent quarterly report filed pursuant to the Act;

(3) Ratio of earnings to fixed charges for the two most recent fiscal years and the in-

terim periods provided under Item 14(a)(2); and

(4) Book value per share as of the most recent fiscal year end and as of the date of the latest interim balance sheet provided under Item 14(a)(2).

(b) If material, provide pro forma data disclosing the effect of the Rule 13e-3 transaction on: (1) The issuer's balance sheet as of the most recent fiscal year end and the latest interim balance sheet provided under Item 14(a)(2);

(2) The issuer's statement of income, earnings per share amounts, and ratio of earnings to fixed charges for the most recent fiscal year and the latest interim period provided under Item 14(a)(2); and

(3) The issuer's book value per share as of the most recent fiscal year end and as of the latest interim balance sheet date provided under Item 14(a)(2).

Item 15. Persons and Assets Employed, Retained or Utilized. (a) Identify and describe the purpose for which any officer, employee, class of employees or corporate asset of the issuer (excluding corporate assets which are proposed to be used as consideration for purchases of securities which are disclosed in Item 6 of this schedule) has been or is proposed to be employed, availed of or utilized by the issuer or affiliate in connection with the Rule 13e-3 transaction.

(b) Identify all persons and classes of persons (excluding officers, employees and class of employees who have been identified in Item 15(a) of this Schedule) employed, retained or to be compensated by the person filing this statement, or by any person on behalf of the person filing this statement, to make solicitations or recommendations in connection with the Rule 13e-3 transaction and provide a summary of the material terms of such employment, retainer or arrangement for compensation.

Item 16. Additional Information. Furnish such additional material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not materially misleading.

Item 17. Material to be Filed as Exhibits. Furnish a copy of:

(a) Any loan agreement referred to in Item 6 of this Schedule;

Instruction: The identity of any bank which is a party to a loan agreement need not be disclosed if the person filing the statement has requested that the identity of such bank not be made available to the public pursuant to Item 6 of this schedule.

(b) Any report, opinion or appraisal referred to in Items 8(d) or 9 of this schedule;

(c) Any document setting forth the terms of any contract, arrangements or understandings or relationships referred to in Item 11 of this schedule; and

(d) Any disclosure materials furnished to security holders in connection with the transaction pursuant to Rule 13e-3(d) [§ 240.13e-3(d)].

(e) A detailed statement describing the appraisal rights and the procedures for exercising such appraisal rights which are referred to in Item 13(a) of this schedule.

(f) If any oral solicitation of or recommendations to security holders referred to in Item 15(b) are to be made by or on behalf of the person filing this statement, any written instruction, form or other material which is furnished to the persons making the actual oral solicitation or recommendation for their use, directly or indirectly, in connection with the Rule 13e-3 transaction.

SIGNATURE

After due inquiry and to the best of my knowledge and belief, I certify that the information set forth in this statement is true, complete and correct.

(Date)———————————

(Signature)—————————

(Name and Title)——————

The original statement shall be signed by each person on whose behalf the statement is filed or his authorized representative. If the statement is signed on behalf of a person by his authorized representative (other than an executive officer or general partner of the person filing this statement), evidence of the representative's authority to sign on behalf of such person shall be filed with the statement. The name and any title of each person who signs the statement shall be typed or printed beneath his signature.

(Sec. 17(a), 19(a), 48 Stat. 84, 85; secs. 3(b), 10(b), 13(e), 14(a), 14(d), 14(e), 23(a), 48 Stat. 882, 894, 895, 891, 901; sec. 209, 48 Stat. 908; sec. 203(a), 49 Stat. 704; sec. 8, 49 Stat. 1379; sec. 10, 68 Stat. 686; sec. 5, 78 Stat. 569, 570; secs. 2, 3, 82 Stat. 454, 455; secs. 1, 2, 3-5, 84 Stat. 1497; secs. 3, 18, 89 Stat. 97, 155; 15 U.S.C. 77s(a), 77s(a), 78c(b), 78j(b), 78m(e), 78n(a), 78n(c), 78n(e), 78w(a))

[44 FR 46743, Aug. 8, 1979, as amended at 51 FR 2477, Jan. 17, 1986]

§ 240.13e–101 Schedule 13E–4. Tender offer statement pursuant to section 13(e)(1) of the Securities Exchange Act of 1934 and § 240.13e–4 thereunder.

Securities and Exchange Commission
Washington, D.C.

Issuer Tender Offer Statement

Pursuant to Section 13(e)(1) of the Securities Exchange Act of 1934

Mr. RANGEL. Mr. Clarke.

STATEMENT OF HON. ROBERT L. CLARKE, COMPTROLLER OF THE CURRENCY

Mr. CLARKE. Thank you. I am pleased to have this opportunity to testify before you today.

My written statement covers in detail several aspects of commercial bank participation in highly leveraged transactions, particularly the kinds of tranactions on which the Office of the Comptroller of the Currency (OCC) has focused its attention, data on the extent of commercial bank involvement, the risks associated with commercial bank participation, and the ways in which the OCC will assess how banks manage their highly leveraged transaction (HLT) lending. Mr. Chairman, I would like to talk to you this afternoon about the supervisory picture. And, in particular, I want to focus on what the OCC has done and what it will do to ensure that national banks manage prudently.

Any bank activity—including participation in financing highly leveraged transactions—must be consistent with safe and sound banking principles and practices. We at the OCC recognize that HLT financings, if improperly managed, could expose banks to risks that are inconsistent with principles of safety and soundness. But so, too, can other types of financing.

The challenge facing bankers who engage in HLT financing is twofold: to develop operating policies and procedures that will enable them to assess the risks in a particular transaction accurately and to diversify the risk if they decide to participate in the transaction.

Bank supervisors must ensure that risk-taking by banks stays within prudent limits. If we discover that a bank does not have adequate lending policies or does not judge the quality of its loans accurately, we will take corrective action.

But the bank supervisors must avoid taking actions that are too sweeping. Blanket restrictions on bank participation in highly leveraged transactions would penalize sound credits along with risky ones. It could also impede bank lending to small businesses, as many small-business loans involve high leverage ratios similar to those in the highly publicized leveraged buyouts.

In short, the role of a commercial bank is to assess risks and decide which credits it wants to extend. And our job as bank supervisors is to ensure that those decisions are made on a sound basis.

The OCC supervises the risk exposure of national banks in two basic ways. The first way is through regulation. Our regulations—and the Federal statutes from which they are derived—define permissible bank assets and lending practices.

The second way is through examination. We use examinations and other procedures to check compliance with laws and regulations, to review investment and loan policies, to examine the quality of the assets in national bank portfolios and to ensure that banks are valuing assets on their balance sheets properly.

A number of Federal statutes and regulatory rulings impose controls on bank exposure to highly leveraged transactions. They are discussed in detail in my written testimony. But I would like to stress that for years statutes have limited the amount that a bank can lend to a single borrower and have prohibited national banks from holding the high yield debt securities that are often involved in highly leveraged transactions.

The OCC issues circulars and bulletins to our examiners and to executives of national banks to notify them of our concerns about banking risks and to offer suggestions for managing those risks. In 1985, we warned our national banks that we would view a commitment to acquire so-called "junk" bonds to be a violation of Federal law. And a circular that was issued a year earlier warned about risks that may arise in connection with redistributing credits through the banking system—one of the risks that arise in HLT financings. That circular described a number of controls that we believe are appropriate for bank buyers of loans and participations.

As I said, the second way we supervise the risk exposure of national banks is through the examination process. In a bank examination, loan portfolios are evaluated to ensure: (1) that the bank is granting the loans on a sound and collectible basis, (2) that the bank's funds are being invested profitably for the benefit of shareholders and the protection of depositors and (3) that the loans are properly valued on the bank's balance sheet.

As I said before, we believe that the risks assumed by banks engaged in HLT lending are essentially credit risks—and thus are not substantially different from the risks associated with other types of bank lending. The risks to the banks are higher because the leverage of the borrower is higher. But as with other types of bank lending, banks can adopt procedures to ensure that these risks are properly managed.

We believe that we have the means to assess how banks manage those risks. But—to do an even better job—we recognized that we needed a greater familiarity with the details of HLT lending by national banks. In short, we wanted more information to help us answer the two key questions that determine whether any banking activity is consistent with bank safety and soundness principles: (1) Do banks really understand the risks they are assuming, and (2) Are banks able to manage those risks adequately?

To gather that information, last spring we began a study of leveraged financing activities at 16 of the largest national banks. We wanted to assess the extent and types of HLT financing by these national banks. And we wanted to see what specific policies and procedures they had in place to evaluate and control their HLT exposure. A team of examiners visited each bank, interviewed management, and prepared a profile of each bank's participation in HLT financing.

Most of the banks surveyed have established limits both on their total HLT exposure and on individual transactions. The banks tend to place strict limits on the amount of a given transaction they will hold for their own portfolio. They sell to participants in order to reduce their initial commitment.

The banks also reported—based on their internal credit classification systems—that the credit quality of their HLT loan portfolio has generally been satisfactory to date, that classified and problem loans have not been excessive, and that losses have been minimal.

These findings are reassuring. But we are concerned that the high fees and returns available on HLT loans might tempt some banks to commit funds to transactions without first establishing two important controls. Those controls are: Developing standards for evaluating credit risks and placing prudent limits on exposure to losses.

The OCC's supervisory response to bank financing of highly leveraged transactions is, therefore, taking two forms. The agency will examine the process by which national banks participate in HLT financing. And it will also examine the credit quality of selected highly leveraged transactions.

First, I would like to discuss process. Our examination procedures focus on the adequacy of bank management systems and control measures. We believe that the best way to identify self-perpetuating managerial weaknesses is by analyzing the processes and systems that a bank uses to conduct its business. Last December, we issued a circular that lists detailed examination guidelines, including a description of the process that banks should—at a minimum—follow in structuring their financing of HLT's. That circular is described in detail in my written statement.

Furthermore, Mr. Chairman, at the country's eleven largest national banks the OCC keeps examination staff on full-time duty because of the complexities involved in supervising institutions of their size. This continuous presence provides us with greater knowledge of the day-to-day managerial decisions at these complex institutions than would otherwise be available—and it increases our predictive capability in the supervision of these institutions. Over the next several months the OCC intends to start targeted examinations by onsite and other senior examiners of the HLT lending process at the largest banks—and to conduct similar examinations at major regional banks.

Turning to credit quality, Mr. Chairman, once a year the OCC, together with the FDIC and the Federal Reserve System, performs a joint supervisory review of all loans within the system of insured depository institutions that qualify as Shared National Credits. The three agency Shared National Credit program assesses large loans that are shared by two or more regulated depository institutions. Each Shared National Credit is reviewed at one institution, usually the agent bank. The credit quality rating assigned by examiners is then reported to all participating institutions. Those ratings are subsequently used in examinations of the participating banks. Thus the program avoids duplicate reviews of the same loan and ensures consistent treatment of all banks participating in the credit.

We think most HLT financings currently qualify as Shared National Credits. This year we have made minor modifications to the Shared National Credits system to report those loans that have the characteristics of HLTs and to permit us to capture both the outstanding amount of the banks' HLT financings and their total commitments. When the results of these examinations are compiled into our Shared National Credit database, we will have a more detailed picture of both the quantity and quality of HLT financing provided by banks.

In summary, Mr. Chairman and members of the committee, I would just like to stress again that we at the OCC believe that HLT loans are not fundamentally different from other types of bank lending. As with any loans, some are riskier than others. With appropriate direction and controls, those risks can be managed. Our objective is to make sure that they are.

Thank you very much.

[The statement of Mr. Clarke follows:]

For Release:
January 31, 1989, 10:00 a.m.

TESTIMONY OF
ROBERT L. CLARKE
COMPTROLLER OF THE CURRENCY
Before the
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
January 31, 1989

Mr. Chairman and members of the Committee, I am pleased to have this opportunity to testify on the role commercial banks play in financing highly leveraged transactions and on the steps that the Office of the Comptroller of the Currency (OCC) is taking to bring about the prudent management of those financings.

Several highly leveraged transactions, particularly some that involve the buyout of public shareholders of corporations, have been in the headlines recently. My objective this morning is not to discuss the broad tax, competitive, and other issues concerning the role of highly leveraged transactions in the economy, which the Committee is considering. Instead, my mission today is to present the perspective of the OCC as the supervisor of national banks. As such, we want bank participation in financing highly leveraged transactions (HLTs) to be consistent with safe and sound banking practices.

Today I would like to accomplish the following: 1) outline the kinds of transactions on which the OCC has focused its attention; 2) describe the ways in which commercial banks participate in financing HLTs and present some data on the extent of commercial bank involvement; 3) discuss the risks associated with commercial bank participation in HLTs; and 4) discuss the OCC's methods for assessing how banks manage their HLT-associated lending. One important part of our efforts thus far is an examining circular, issued on December 14, 1988, which outlines for our bank examiners and the national banks we supervise, some important components of assessing the HLT-related lending activities of national banks.

HIGHLY LEVERAGED TRANSACTIONS

The most widely recognized highly leveraged transactions are leveraged buyouts, a term that usually refers to a corporate takeover, either by the target company's managers or by outside buyers, that is financed primarily with debt. Focusing solely on leveraged buyouts, however, is too narrow a perspective. There are other highly leveraged transactions that do not involve a corporate takeover that should also be considered. Thus, the transactions in which we are interested include the following:

- Any purchase of assets or equity of a company that is financed largely by debt, including debt secured by the purchased assets or equity;

- Any financing transaction that leaves a firm with a debt-to-equity ratio that is significantly greater than is normal for the firm's industry; and

- Any purchase of the assets or stock of a firm that employs financing that leaves the firm with relatively little unobligated cashflow and may require the liquidation of some assets to reduce the debt burden to a manageable level over the long term.

All of these transactions produce the same basic result: a substantial increase in the firm's debt relative to shareholder equity.

Because there is no satisfactory single definition of a highly leveraged transaction, there is no universal agreement about how many HLTs have taken place or the volume of debt associated with those transactions. However, estimates from different analysts are reasonably consistent and generally range between $150 billion and $180 billion. For example, using a private database source, the Federal Reserve Bank of Chicago counts about $155 billion in leveraged buyouts from 1984 through 1988; in a recent study, Morgan Stanley & Co. estimated that financing for the 350 major leveraged buyouts since 1978 totaled $166 billion; a PaineWebber study of leveraged buyouts of $100 million or more performed since 1981 estimates total leveraged buyout financing at $178 billion.

COMMERCIAL BANK PARTICIPATION IN HLTs

Role of Commercial Banks

Fundamentally, bank financing of highly leveraged transactions is not different from other types of commercial lending. The basic ingredients of a sound credit policy must be applied, including a thorough credit analysis, an analysis of cash-flow projections under a variety of economic conditions, and an assessment of the competence of management. In essence, the lender must assess how the borrower plans to repay the debt--and be satisfied that it can.

Commercial banking organizations may participate in HLT financings in a number of ways. The vast majority of national bank involvement in HLTs is in the form of term loans and bridge loans--traditional banking activities. Term loans are senior debt, generally secured by the assets of the target company. As the name implies, senior debt has priority over other creditors and equity investors, and is thus the least risky form of HLT financing. In the typical highly leveraged transaction, between one-half and two-thirds of the financing may be provided by banks in the form of term loans. Bridge loans are typically short-term loans that provide financing while the other parts of the total long-term financing package are being underwritten and distributed.

Because national banks are prohibited by 12 USC 24 from holding equity securities and are limited in the types of debt securities that they may hold, banking organization have participated to a much lesser extent, and through their bank holding company parents and affiliates, in mezzanine financing and equity financing of highly leveraged transactions. Mezzanine financing is a general term that refers to any portion of a financing package that ranks behind senior debt, but before equity, in terms of creditor standing. Examples include debt secured by a junior rather than a senior lien on the borrower's assets, and debt that is fully subordinated so that in the event of default, the creditor would receive no principal or interest payments until the senior debt is fully repaid. Included in this category of financing are high-yield, or so-called "junk" bonds. And, of course, the equity financing portion of a highly leveraged transaction consists of the common or preferred stock that is issued.

Extent of Commercial Bank Lending

At present, there is no distinction made in commercial bank call reports between highly leveraged transactions and other corporate lending. Consequently, the OCC does not have precise data concerning the total volume of HLT credits currently held by U.S. banks. However, data regarding the dollar volume of HLTs will be collected during the 1989 examination of Shared National Credits. A Shared National Credit is any loan of $20 million or more that is shared by two or more depository institutions. The

Shared National Credits examination process began at the OCC in 1975; the Federal Reserve System and the FDIC joined the OCC effort shortly thereafter. Because most HLT loans are syndicated, we expect the survey of Shared National Credits to capture the large majority of HLT loans by commercial banks.

Just as the estimates of total leveraged buyout financing vary, estimates that have been published by private firms of the volume of leveraged buyout financings underwritten and held by commercial banks also vary. For example, an October 1988 survey by Prudential-Bache Securities of the 10 largest U.S. commercial banks found an aggregate LBO exposure of $18.5 billion. A November 1988 survey by PaineWebber of 28 large U.S. banks reported an aggregate exposure of $28.3 billion dollars, equal to 3.6 percent of total loans at those banks.

A broader estimate of the volume of LBO transactions underwritten by commercial banks comes from Loan Pricing Corporation, a private database service. The Loan Pricing Corporation database, which is not exhaustive, lists about 380 LBO loans at commercial banks as of December 1988, totaling slightly less than $80 billion. Those data are gathered from reports filed with the Securities and Exchange Commission by publicly held companies.

The $80 billion figure reported by the Loan Pricing Corporation represents the amount of the banks' original loan commitments. The banks reporting the commitments are usually part of a syndication group that sells participations in the financing to others, including foreign banks. Thus, the $80 billion figure does not represent the book value of LBO financing actually held by U.S. commercial banks as of December 1988; rather, it represents the volume of the commercial bank loan commitments reported to the SEC and interpreted by Loan Pricing Corporation as LBO financings.

Although these amounts are large, the total volume of LBO loan commitments reported by Loan Pricing Corporation represents less than three percent of the total assets of U.S. commercial banks. Moreover, involvement in highly leveraged transaction financing to date has been limited to a small number of multinational and regional banks, and, using a broad definition of HLTs, averages less than ten percent of their loan portfolios. Based on discussions with national banks active in HLT lending, it appears that the vast majority of the largest HLT lenders restrict their holdings of loans to any particular firm involved in a HLT to a maximum of $50 million.

Potential Risks in HLT Lending By Commercial Banks

Lending to highly leveraged corporations, like any extension of credit, involves risks. The more debt a firm has, other things being equal, the more vulnerable it is to distress stemming from a decrease in its revenues. That observation has caused concern that an economic downturn or other economic shock could lead to a large number of bankruptcies among highly leveraged corporations and result in major losses to their lenders, including commercial banks.

The sensitivity of a leveraged firm's ability to service its debt under a variety of circumstances is a valid concern--and one that appears to be generally recognized by those who engage in highly leveraged transactions. Many firms involved in HLTs have characteristics that reduce their vulnerability to business cycles, including low capital investment and R&D requirements, steady cash flows, and stable demand. Moreover, the firms that engage in HLTs frequently have free-standing units, often undervalued, which can be sold to reduce the debt load.

When we consider whether bank participation in HLT financing is consistent with safety and soundness principles, there are two key questions:

> First, can banks correctly evaluate the risks involved in financing a highly leveraged transaction? That is, can they accurately judge the ability of the borrower to service its debt throughout the range of business conditions the firm can be expected to face over the life of the loan?
>
> And second, are those risks acceptable, or can they be reduced to an acceptable level through risk-sharing with other banks and portfolio diversification?

The most significant source of risk in highly leveraged transactions is the possibility that competing bidders will over-value a firm's assets, and as a result, assume more debt than the firm can service. The principal protection against overlending to HLT firms is a thorough examination of the target firm's assets and earnings history by the banks involved in financing the transaction. That is essentially the process banks go through in evaluating all commercial loans, but on a much larger scale; HLT financing requires a high level of financial expertise, pricing sophistication, and expert analytical skills.

Credit risk cannot be eliminated. It can be managed, however, by careful underwriting and by diversification. A properly managed HLT portfolio, consisting of loans to a wide variety of firms in many industries and regions can substantially reduce a bank's exposure to cyclical declines.

In addition to credit risk, banks that originate financing for highly leveraged transactions may be exposed to distribution risk. This includes the risk that the originating bank will have difficulty finding secondary buyers for HLT debt, and either be forced to offer more generous credit terms (cutting into its own returns), or be left holding more of its initial loan commitment than was intended. There are also some legal risks in connection with the distribution of this debt. For example, loan purchasers may seek recourse from the originating banks if a transaction sours.

It is difficult to estimate the magnitude of distribution risk, because the system that has arisen for syndicating and distributing HLT debt has not yet been seriously tested, either by a shortage of willing lenders or by legal challenge. Our current efforts are aimed at ensuring that banks proceed cautiously, and pay close attention to the availability of syndication resources and secondary lenders before making loan commitments.

Another risk of particular concern to the OCC is the possibility that conflicts of interest may arise when a banking company participates in more than one tier of financing in a single highly leveraged transaction. For example, it is possible that a bank holding company's equity interest in a borrower could conflict with a subsidiary bank's obligations to an entity that is purchasing senior debt of the same borrower. The OCC's examining circular on highly leveraged transactions, which I mentioned at the beginning of this statement, specifically instructs examiners to make a determination of the adequacy of a bank's procedural safeguards against such conflicts of interest.

EXISTING REGULATORY CONTROLS ON BANK HLT FINANCING

Before I describe the specific steps the OCC has taken to assess how well banks manage the risks involved in financing highly leveraged transactions, it is important to note the existing regulatory and supervisory controls on the credit exposures of all national banks. The OCC regulates and supervises the risk exposure of national banks in two basic ways. First, federal statutes and regulations define permissible bank assets and lending practices. Second, we use examinations and other supervisory procedures to check compliance with these statutes and regulations, to review investment and loan policies, and to examine the quality of the assets in national bank portfolios, and to ensure that banks are valuing those assets properly on their balance sheets.

Federal Statutes and Regulatory Rulings

A number of federal statutes impose controls on bank exposure to highly leveraged transactions. The lending-limit provision of 12 USC 84 restricts unsecured loans to a single borrower to 15 percent of the bank's capital and surplus; loans secured by readily marketable collateral are permitted up to an additional 10 percent.

The securities provisions of 12 USC 24 and the OCC's supporting regulations in 12 CFR 1 govern the investment securities powers of national banks. National banks are not permitted to hold equity securities and are permitted to hold only investment-grade debt securities. That group generally includes investment securities with the four highest rating grades and unrated securities of equivalent quality. Thus, national banks are prohibited from holding most high-yield debt securities often involved in highly leveraged transactions.

In addition, the OCC issues circulars and bulletins to our examiners and to executives of national banks to notify them of our concerns about banking risks, and to offer suggestions for managing them. For example, to reinforce the prohibition against holding less-than-investment grade securities, the OCC in May 1985 issued Banking Bulletin 85-12 concerning high-yield ("junk") bonds; that bulletin stated that national bank commitments to acquire such securities will be viewed as violations of 12 USC 24 and 12 CFR 1.

Another issuance, OCC Banking Circular 181, issued in August 1984, covers risks that may arise in connection with redistributing credits throughout the banking system--one of the risks that arises in HLT financings. Banking Circular 181 describes a number of controls that we believe are appropriate for bank buyers of loans and participations. These include, but are not limited to: (i) written lending policies and procedures regarding distributed credits; (ii) independent credit analysis by the purchasing bank; (iii) agreement by the obligor to make full credit information available to the selling bank; (iv) agreement by the selling bank to provide that information to the purchaser; and (v) written documentation of recourse arrangements outlining the rights and obligations of each party.

Bank Examinations

Aside from the existing statutes, rulings, and supervisory bulletins that guide the lending and investment powers of national banks, the major influence we have on the types, maturity, and quality of credit exposures held by national banks is through supervision. In a bank examination, loan portfolios are evaluated to ensure that the bank is granting the loans on a sound and collectible basis, that the bank's funds are being invested profitably for the benefit of the shareholders and the protection of the depositors, and that loans are properly valued on the bank's balance sheet.

Typically, this process starts with a review of the bank's formal lending policies, and proceeds to an examination of the quality of individual loans, with the greatest attention given to the larger lines of credit. The most significant factors reviewed include the payment history on the loan, the borrower's financial condition, the quality of pledged collateral, and the completeness of the bank's loan file documentation. Credits determined to have excessive risks or questionable collection characteristics are then classified into one of four categories (special mention, substandard, doubtful, or loss), and the results of the examination are discussed with management and directors.

OCC Survey of HLT Financing at Major National Banks

We believe that the risks assumed by banks engaged in HLT lending are not substantially different from the risks associated with other types of bank lending. As with other types of bank lending, banks can adopt procedures to see that these risks are properly managed. We believe that we have at our disposal the means to assess how banks manage those risks. To do our job well, however, we recognize that we need a greater familiarity with the particulars of HLT lending by national banks. In essence, we need information that will enable us to answer the questions posed earlier: do banks really understand the risks they are assuming, and are banks able to manage those risks adequately?

To gather that information, we initiated, in the spring of 1988, a study of leveraged financing activities at 16 of the largest national banks. The purpose of the study was to assess the extent and types of HLT financing by these national banks, and to see what specific policies and procedures they had in place to control their HLT exposure. A team of examiners visited each bank and, based upon a series of interviews with senior management, prepared a profile of each bank's participation in HLT financing.

Most of the banks surveyed have established limits on both their aggregate HLT exposure and on individual transactions. The banks tend to place strict limits on the amount of a given transaction they will hold for their own portfolio: they sell down their initial commitment position, using networks to redistribute portions of the transaction to other investors. The banks also reported, based on their internal credit classification system, that the credit quality of the HLT loan portfolio has generally been satisfactory to date; classified and problem loans have not been excessive, and losses have been minimal.

Although these findings were reassuring, we are concerned that the high fees and returns available on HLT loans might tempt some banks to commit funds to transactions without first developing standards for evaluating financing risks, or without placing prudent limits on their exposure to losses. The OCC's supervisory response to bank financing of highly leveraged transactions is thus taking two forms: the agency will examine the process by which national banks perform HLT financing, and it will also examine the credit quality of selected highly leveraged transactions themselves.

Supervising the Process of HLT Financing

The OCC's examination procedures focus on the adequacy of the bank's management systems and control measures. Although we perform detailed examinations of a bank's actual operations and practices when necessary, our examination philosophy is that the best way to identify self-perpetuating managerial weaknesses is through an analysis of the processes and systems a bank uses to conduct its business.

Accordingly, a bank's policies and procedures, and its control systems, are the focus of OCC Examining Circular 245 regarding Highly Leveraged Transactions. That circular, issued December 15, 1988, lists detailed examination guidelines that outline how we believe banks should, at a minimum, structure the process of financing HLTs. It was distributed not only to all OCC examination personnel, but also to the Chief Executive Officers of all national banks.

The guidelines begin by asking whether the bank's board has adopted a written policy statement that clearly (1) defines highly leveraged transactions, (2) defines the bank's philosophy toward HLT financing, and (3) outlines the bank's objectives in providing the service. Equally important is whether the board has approved a separate lending policy that covers the process of approving and reporting HLT exposures. The guidelines note that a good lending policy will specify control mechanisms, underwriting criteria, and regular review of the HLT portfolio by line management. Examiners are also asked to evaluate the ability of management information systems to record and monitor the HLT exposure, screen the portfolio for loan concentrations by industry, and track changes in risk ratings of individual loans.

Because HLT financings are often syndicated to a large number of banks throughout the United States and the world, the OCC, pursuant to our guidelines, expects both originating and purchasing banks to adopt formal policies and procedures covering the sale and distribution and purchase of participations in such transactions. Management and the board of directors are expected to ensure full compliance with the OCC's guidelines governing asset participations and purchases as detailed in the previously mentioned OCC Banking Circular 181. They must also establish policies to review legal and regulatory issues associated with HLT financing. Examiners must assess the bank's internal review of its HLT portfolio, which, at a minimum, should include an annual review of all HLT credits as a separate portfolio, to supplement the bank's normal management control process. Further, examiners are directed to assess how the bank incorporates the risks related to HLT financing into its determination of the adequacy of the loan loss reserve.

The OCC has kept examination staff on full-time duty at the country's eleven largest national banks for the last several years. That continuous presence provides us with greater knowledge of the day-to-day managerial decisions at these complex institutions than would otherwise be available. In doing so, it increases our sensitivity to the general condition of those institutions. This on-site monitoring program has increased our predictive capability in the supervision of the nation's largest banks and has quickened our response to problems at some institutions.

OCC's permanent on-site staff, along with other senior examiners, is scheduled, over the next several months, to start targeted examinations of the HLT lending process at the largest banks. We have also scheduled similar examinations at major regional banks.

Supervising the Credit Quality of HLT Financing

The second type of supervisory function performed by the OCC concerning bank financing of HLTs involves examining the credit quality of selected transactions.

As indicated previously, once a year, the OCC, together with the FDIC and the Federal Reserve System, performs a joint supervisory review of all loans within the system of insured depository institutions that qualify as Shared National Credits. Each Shared National Credit is reviewed at one institution--usually the agent bank--and the credit quality rating assigned by examiners is reported to all participating institutions. Those ratings are subsequently used in examinations of the participating banks, avoiding duplicate reviews of the same loan and ensuring consistent treatment of all banks participating in the credit.

We think most HLT financings currently qualify as Shared National Credits, and this year we have made minor modifications to the Shared National Credits system in order to refine bank reporting of those loans. Another modification will permit us to capture both the banks' outstandings on HLT financings, as well as their total commitments.

During the credit examination of these loans, examiners will assign each loan to one of five categories: pass, special mention, substandard, doubtful, and loss. When the results are compiled into our Shared National Credit database, we will have a more detailed picture of both the quantity and the quality of HLT financing provided by banks. For example, each credit will carry a standard industrial classification code, so we will be able to quantify the aggregate degree of diversification in national bank HLT portfolios. The credit ratings assigned by the examiners will also permit us to measure the credit quality of bank HLT exposures.

CONCLUSION

We recognize that HLT financings, if improperly managed, could expose banks to risks that are inconsistent with principles of safety and soundness, but so can other types of financing. The challenge facing bankers who engage in HLT financing is to develop policies and procedures that will enable them to assess the risks in a particular transaction accurately and to diversify the risk if they decide to participate in the transaction.

Bank supervisors must ensure that risk-taking by banks stays within prudent limits. If a bank does not have adequate lending policies or does not accurately value its loans, we will take action to make sure that they do. But bank supervisors must avoid actions that are too sweeping. Blanket restrictions on lending to highly leveraged firms, rather than allowing banks to assess potential risks and made decisions based on those assessments, would penalize sound credits along with risky ones. It could also impede bank lending to small businesses, as many small-business loans involve leverage ratios similar to those in the highly publicized leveraged buyouts.

In the final analysis, we must keep in mind that HLT loans are not fundamentally different from other types of bank lending. As with any loans, some are riskier than others. The role of a commercial bank is to assess risks and decide which credits it wants to extend. Our job as bank supervisors is to ensure that those decisions are made on a sound basis.

Mr. RANGEL. Thank you, Mr. Clarke. The next witness is L.W. Seidman, Chairman of the Federal Deposit Insurance Corporation.

STATEMENT OF HON. L. WILLIAM SEIDMAN, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. SEIDMAN. Thank you for inviting me to be with you on this important subject. As the insurer of the banking system, the FDIC is vitally interested in this issue. I will comment on three areas in my presentation. First, overall debt servicing risk as it relates to LBO's.

Second, tax bias toward debt in our system and a suggestion on how we might approach fixing it.

Third, the bank regulators' efforts to deal with LBO risk in banks.

With regard to overall debt servicing risks, American corporations are going increasingly into debt. Corporate debt totaled $1.8 trillion as of the third quarter of 1988, compared with less than $1 trillion in 1982. Current nonfinancial corporate debt service ratio—defined as a ratio of interest expense to earnings before taxes—stands at approximately 32 percent. That is the coverage to pay the debt. This is a key risk ratio. The burden on corporate cash flows by debt obligations is now above the level for every year in the 1970's, but is below the debt burden for 1982, which, however, was a recessionary period.

The worrisome evaluation of this ratio is that the high level 9of interest cost as a percentage of income has occurred during a strong economic upswing and not during a recession. This ratio normally has gone up during a recession as a result of reduced income caused by the recession. Thus, the ratio normally is one that goes up in a recession. During the next recession, a normal rise in debt service ratio would put the ratio well above previous record levels. This could substantially increase the severity of the recession.

Unfortunately, we never know if the level of debt to debt servicing ability is too high until it is too late—after it has been proven by unfortunate actions in the real world. Those who find the increasing levels of debt to servicing ability acceptable today, are more sanguine about that than we are.

With respect to the tax system and the bias toward debt, as the Secretary of the Treasury has pointed out, it seems clear that is a factor in the increasing debt in our system today. We recommend that Congress explore ways to reverse the built-in bias toward debt financing. We do not favor limitation on interest deductions because of the difficulty of defining good and bad interest payments.

We suggest that the best way to reverse the bias is for dividends to carry with them a tax credit for corporate tax paid. In receiving a dividend, a shareholder would be able to take credit for all or part of the corporate tax against his personal tax. This suggestion is in fact almost like a withholding tax on dividends. Of course, the same thing could be applied to interest. In other words, payments both of interest and dividends would first have a withholding by the corporation against the income which the individual would receive. That provides complete equality in the treatment of the interest and the dividends. This corporation tax paid credit on dividends and interest would have a far less drastic effect on tax revenues than allowing a full deduction of dividends. In fact, if interest were included, it might increase revenues in the early years. As you remember, there was a provision for withholding interest before the Congress at one time in which the Treasury indicated there were many billion dollars of interest income revenues escaping taxation under current levels. I remember the banks were violently against it. I might indicate at this time the banks are very much occupied in other areas and might not be so interested in waging that battle again.

If dividends were deducted, I believe corporations would be moved to pay out all their earnings in dividends to avoid tax. Certainly it is not desirable that they do so, because that is a primary source of investment.

While we do not have the resources to do the entire costing out of this program, it seems to me that it would be useful for the talented staff of your committee to look into that to see at what level of credit you could handle the tax loss involved.

Finally, with respect to bank regulators' effort to deal with LBO's, you heard the excellent presentation of the Comptroller. We subscribed in all the things he is doing and will be doing some of the same things ourselves. Since the overall debt, corporate debt level does increase risk in the system, it is obviously important that we look at these LBO's from that point of view. However, we must take note of the fact that this is an important source of income for banks. If they are restricted, that will have an effect on banks because they are not allowed to operate in the securities side of financing.

Furthermore, the market discipline imposed by LBO's and the removal of often entrenched management are positive results evident in some LBO transactions. Most of the LBO financing in the United States are originated by the nation's largest banks. Ten multinational banks serve as the originating bank in most LBO transactions. As of September 30, 1988, reported LBO loans outstanding in these institutions were approximately $20.2 billion. This represents only 4.4 percent of book value of these loans, but 61.8 percent of their combined common equities. While LBO loan concentration as a percentage of bank equities are relatively high at these levels, the level exposure is fairly stable since banks sell significant portions of these loans shortly after origination. Some regional banks are beginning to get into LBO's, but generally the smallest banks have not. We have been specifically monitoring LBO lending for several years and will continue to closely monitor it. We regularly survey our regions to determine the extent of LBO exposure in the banks. Our information at this time is that banks are managing their LBO financing risks prudently. However, the increasing concentration could prove a significant risk. Finally, the question has been asked, and one might ponder why we have to deal with such a rapid increase of leverage in the system today. The rules have not been changed in any substantial way. I believe what has happened is that there is a willingness to accept far greater risk than in the past. Perhaps it is because it is the last of the Great Depression generation which has now departed the scene. Today banks see this as an exception strategy. High debt risk is the name of the game. Inflation has taught the rewards of debt. If this conjecture does in fact have any merit, review of the previous high-risk period in our history might be proper if we seek to avoid history repeating itself.

[The statement of Mr. L. William Seidman follows:]

STATEMENT OF L. WILLIAM SEIDMAN, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Good morning, Mr. Chairman and members of the Committee. I thank you for this opportunity to address the Committee on the impact of "leveraged buyouts" ("LBOs") on our economy, and particularly on the banking industry. As the insurer of the banking system, the Federal Deposit Insurance Corporation is vitally interested in this matter.

My remarks will focus on four specific areas: first, the definition of LBOs; second, the potential effects of escalating corporate debt on the U.S economy; third, specific banking concerns regarding the volume of LBO lending, concentrations of lending and credit quality; and, finally, the FDIC's supervisory role relative to LBO activities in the banking system.

DEFINITION

"Leveraged buyout" may mean different things to different people. As of yet, there is no universal definition. Generally, LBOs refer to management-led leveraged buyouts (or as termed by Treasury Secretary Brady -- leveraged takeovers) and highly leveraged acquisitions. An LBO is one type of "highly leveraged transaction" ("HLT"), a more encompassing term that includes LBOs and other transactions financed in significant part by debt. We use the acronyms "LBO" and "HLT" interchangeably in this statement.

There is no universal standard for determining whether a company is "highly leveraged." What is considered high in one industry may not be considered high in another. Bankers Trust Company defines an HLT as "any transaction where the total debt incurred by the company -- including working capital loans, mezzanine financing [that is, instruments with combined debt and equity characteristics] and senior debt -- exceeds 70 percent of the borrowers' capital structure." Generally we agree with that definition but, again, it depends on the particular company or industry. Certainly, a firm could be highly leveraged with much lower levels of debt.

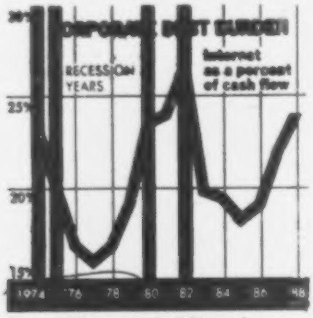
ECONOMIC POLICY CONCERNS

American corporations are going increasingly into debt. Corporate debt (excluding debt of financial institutions) totaled $1.8 trillion as of the third quarter of 1988, compared with less than $1 trillion in 1982. Between 1982 and yearend 1987 corporate debt, as a percentage of the gross national product, rose from 30 percent to 37 percent and, as a percentage of corporate net worth, expanded from 30 to 46 percent. As of year-end 1987, the corporate debt-equity ratio stood at 71 percent on a market-value basis. Although greater than the debt-equity ratios for 1985 and 1986, it was below that for each year from 1974 through 1979. The record high for the debt-equity ratio was approximately 104 percent in 1974.

The Treasury Department has estimated that, for 1988, the amount of corporate debt incurred through LBO activity is over $60 billion, or 3.3 percent of nonfinancial corporate debt. About a third of this debt is in the form of "junk bonds" while the majority is senior debt which is secured by the assets and receivables of the target corporation. Most of the leveraged acquisition lending has occurred in the past two years and is highlighted by the recent $25 billion RJR Nabisco deal engineered by the investment banking firm Kohlberg, Kravis, Roberts & Company.

As previously noted, in absolute terms, the nonfinancial corporate debt level is at record highs -- around $1.8 trillion as of the third quarter of 1988. The current nonfinancial corporate debt-service ratio (as measured by net interest payments divided by pre-tax earnings) stands at approximately 32 percent, and has been rising gradually since 1985. This is the key risk ratio. The burden on corporate cash flows by debt obligations is now above the level for every year in the 1970s, but is below the debt-burden for the 1982 recessionary period. However, the 1982 period was characterized by declining corporate earnings and high interest rates, both contributing to a high debt-service ratio. An important and sometimes overlooked fact is that the current period of increasing debt service ratios differs from highs in the past in that it has occurred while corporate earnings have been robust. Therefore, concern over the financial well-being of highly leveraged corporations in the face of an imminent economic downturn is not unfounded.

Thus, the most worrisome evaluation of the current debt burden is that the high level of interest cost as a percentage of cash flow has occurred during a strong economic upswing and not during a recession. This ratio normally has gone up during a recession as the result of reduced income caused by the downturn. During the next recession a normal rise in the debt-service ratio seen during the slow down would put the ratio well above previous record levels, thus substantially increasing the severity of the recession. This assessment is illustrated by the following graph



Before LBOs, corporate debt rose in recessions and dropped during expansions.

•No one can be sure at what level of debt-servicing capability the entire economy may be jeopardized. The level of debt to debt-servicing ability which is too risky to be acceptable is usually discovered too late -- only after it is proven by unfortunate actions in the real world. Those who find the increasing level of debt to servicing ability acceptable today, are more sanguine than we are.

Why have the number and volume of LBO transactions mushroomed in recent years?

Nobody knows for sure. The U.S. tax code creates a bias toward debt over equity financing in that interest on debt is a tax deductible expense whereas dividends result in double taxation. Still, these tax advantages of debt are longstanding and alone cannot account for this phenomenon.

Moreover, the Tax Reform Act of 1986, which lowered the statutory corporate income tax rate, has served to reduce the relative tax advantage of corporate leverage. Furthermore, the decline in interest rates since the early 1980s has reduced the absolute amount of interest payments that would be subject to this preferential tax treatment.

If Congress should decide to reverse this built-in bias toward debt financing, and we would recommend that they explore ways to do so, we suggest that the best way would be for dividends to carry with them a tax credit for corporate tax paid. We would not recommend a limitation on interest deductions because of the difficulty of defining good and bad interest payments. If our suggestion is adopted, shareholders -- in receiving a dividend -- would be able to take a credit against their personal tax for any corporate tax paid on the dividends received. This would avoid the undesirable effect of an undistributed profits tax if corporate dividends were deductible. If dividends were deductible, corporations would be moved to pay out all their earnings in dividends to avoid tax. This is not desirable as it reduces funds available for investment. In addition, credits would have a far less drastic effect on reducing tax revenues than deductible dividends.

While the debt bias in the tax code remains a factor, two other variables may help explain the pace of LBO activity in the 1980s. First, the diversification programs of many large corporations that began in the mid-to-late 1960s proved to be unproductive in many cases -- that is, the anticipated "synergies" did not occur. Thus, situations exist where the sum of the individual parts of the conglomerate have greater value than the whole. The diminished value in these conglomerates, as evidenced by the large takeover and restructuring premiums we now see, have generated profit opportunities for willing investors or astute managers. New financial institutions -- "buyout specialists" -- have arisen to capture these economic profits and LBOs often have been the vehicle used.

Secondly, financial innovations in the form of high-yield debt instruments have been developed to finance these deals. "Junk bonds" and mezzanine financing are among the vehicles used. These have helped facilitate increased LBO activity because they eliminate size as a deterrent to takeovers.

Are LBOs good or bad for us?

LBOs have some good and bad aspects. In their favor, buyers or owners can profit from LBOs. They can "build up" a failing or floundering company or they can "break up" the company by selling the individual pieces. When done properly, both are positive developments since the new corporate leaders have every incentive to improve management and create more efficient structures. Restoring companies to profitability and realizing their full value leads to a sound return on investment and creates wealth.

On the other hand, there are clear dangers to corporate entities with a high degree of leverage. The ability of corporations to service their debt obligations depends critically upon maintaining stable cash-flows over the business-cycle. The current evidence indicates that most LBO activity has been restricted to industries that have traditionally been fairly well insulated from business-cycles. Nevertheless, higher debt obligations relative to cash-flows place these firms at greater risk.

As we have noted, if a recession should occur, many bankruptcies could result. A large-scale increase in bankruptcies could erode public confidence and convert a mild recession into a severe one. Princeton Professors Ben S. Bernanke and John Y. Campbell recently completed a simulation study of approximately 1,400 large corporations. They concluded that 10 percent of the firms studied would become insolvent if a severe 1974-type recession occurred. Moreover, highly leveraged firms with a low net worth relative to liabilities would have more difficulty tapping the credit market and securing capital to help proceed through the economic slowdown.

While overall corporate debt levels may increase risk, many such transactions may be beneficial by improving productivity and the efficiency of the entities involved. In many cases the market discipline imposed by LBO activity and the subsequent removal of "entrenched management" have salutary effects on the resulting corporate entity. As Professor Michael C. Jensen of the Harvard Business School points out, some buyout specialists of the 1980s are "much more than an expediter of LBO transactions. [Rather, they play] an important role in management after the transaction . . . They choose managers of the firm and influence corporate strategy in important ways." They take an active role in restoring value to the corporate entity that was destroyed due to the lack of effective monitoring by corporate managers. The gains to stockholders are often positive. The total premium to public shareholders ranges from 40 to 56 percent, which captures a part of the value of the firm not realized under the previous management. In support of this view, the initial evidence on LBOs after a buyout points to real increases in productivity and operating efficiency in many cases.

From the standpoint of bank involvement in LBOs, any effort to reduce the relative advantage of high-risk leveraged buyouts over equity buyouts would disadvantage banks. This is because current law restricts bank involvement in equity transactions.

Other areas that deserve careful attention in judging an LBO include the effect of the deal on the firm's employment levels and research-and-development expenditures. Firms may try to introduce cost-cutting measures in these areas in order to service the debt.

Target companies often spend considerable resources to reduce their vulnerability to takeovers. "Poison pills" (which give shareholders special rights to acquire shares at below value prices) and "golden parachutes" (which give senior managers high severance bonuses if they are fired) are examples of costly defenses a company can use to preserve the status quo.

Employee Stock Option Plans ("ESOPs") also have been used to prevent "takeovers." They have become something of a "double-edged sword" in their role in the restructuring of corporate America. On the one hand, they continue to serve the purpose for which they were originally created -- to place greater corporate ownership in employees' hands. The beneficial economic incentives of giving employees a greater stake in the future of the firm remain as real today as they were when ESOP legislation was originally enacted. On the other hand, over the years ESOPs have acquired tax advantages and other features that have made them a tool to both take over other firms and defend against takeovers.

Under current tax law a bank, insurance company, regulated investment company or corporation may exclude from income 50 percent of the gross interest earned from loans to a leveraged ESOP. This advantage allows them to make such loans at a lower rate than for non-ESOP loans. Companies desiring to do takeovers can use an ESOP (where an ESOP borrows funds to purchase employer securities) to raise funds on favorable terms for use in acquiring other entities.

In a leverage ESOP, the stock purchased by the corporation for its employees is held in a suspense account and allocated to the employees' accounts over time as the loan is repaid. Prior to the allocation, the shares may be voted by plan trustees so as to help thwart hostile takeover attempts.

All in all, we would suggest that there are both desirable and undesirable LBO transactions. Thus, care should be taken with respect to placing undue obstacles to such transactions. But clearly the tax system is biased toward use of debt and this is on the way to increasing the level of overall risk in the economy to undesirable levels.

BANKING CONCERNS

Most LBO financings in the United States are originated by our largest banks. Ten multinational banks serve as the originating or lead banks in most LBO transactions. As of September 30, 1988, reported LBO loans outstanding in these institutions were approximately $20.2 billion, representing only 4.4 percent of the book value of all loans in these institutions but 61.8 percent of the combined common equity of these banks. Originating banks generally do not keep all LBO loans in their portfolios. Instead they sell participations to others without recourse and often retain only 10 percent or less of a transaction. Japanese and U.S. banks, insurance companies, pension funds and thrifts have been the principal buyers.

The large banks compete vigorously in the LBO field because of the large profits available (although the spreads have been narrowing of late) and the paucity of profitable lending alternatives. Loan spreads usually approach 200 basis points above conventional type commercial lending. Substantial origination fees and selling fees create significant added inducements. This is important because traditional bank corporate lending is not as large or profitable as in the past. "Blue chip" corporations no longer have as great a need for bank loans because they can sell debt directly in the capital market through commercial paper. Margins on the remaining top corporate loans are thin as foreign and domestic banks compete vigorously for the business.

As stated above, LBO concentrations as a percentage of bank equity are relatively high at the multinational banks. The level of exposure, though, is relatively stable as the banks are selling significant portions of these loans shortly after origination and some LBO loans are beginning to drift into the regional and smaller banks. There are some exceptions, but generally the smallest banks have not acquired LBO concentrations.

Credit quality becomes especially relevant when a concentration of risk assets exceeds 25 percent of a bank's capital. Because LBO loans now average over 50 percent of the equity capital of at least the ten largest multinational banks, the FDIC is concerned about the credit quality of LBO lending, as we are about any concentration at this level. Typically -- but not always --

originating banks keep a portion of the senior debt (which is the highest quality part of a deal), but pass on the mezzanine and equity participation portions to other institutions, including non-bank affiliates of the originating bank. Nevertheless, there is risk. As discussed above, economic downturns or interest rate increases could put leveraged companies in jeopardy and result in loan defaults.

Besides relying on corporate earnings, repayment of many LBO loans also is dependent on receipts from the sale of assets. Predicting what values these sales will bring in an uncertain future marketplace is even more difficult than predicting operating cash flows. Lenders also must be concerned about interest rate risk and, therefore, most prudent LBO deals require hedging techniques by either or both the lender and the borrower in order to minimize this risk.

Banks -- at least the major ones -- grade all their loans on a scale based on credit quality. Loans backed by U.S. Treasury bonds, for example, would be at the top of the quality scale. The majority of LBO loans in commercial banks are graded on the low end of the acceptable investment grade scale. So far, very few LBO transactions have been adversely classified by bank examiners. These loans have been performing and internal grading assessments, for the most part, have been accurate.

No one can speak for the future, however. Current LBO loans have been booked in a favorable economic climate with repayment assumptions predicated on the continuation of a nonrecessionary environment. In the last several years, for example, a few steel companies that restructured with high leverage got into financial difficulty. Revco, once the biggest drug store chain in America, was a major LBO deal that floundered. Nonetheless, downturn in the economy could trigger other LBO bankruptcies and push many of the LBO loans from the "barely acceptable" credit quality category into "substandard" or worse.

Should an economic downturn occur, defaults on excessive LBO debt could increase the risk of bank failures and thereby increase costs to the FDIC insurance fund. Thus, as the insurer of the banking system, we will be closely monitoring LBO transactions to assure that risks are controlled and our insurance fund protected.

FDIC ACTIVITY

We have been monitoring LBO lending for several years. Examination guidelines pertaining to evaluation of LBO loans were distributed to examiners in 1984. The discussion of LBO financing in our Manual of Examination Policies has been updated twice since 1986. We have surveyed our regions to determine the extent of LBO exposure in the banks we supervise and will do so again this year. We are preparing additional guidelines to help examiners and bankers evaluate the adequacy of bank policies, procedures and controls relative to LBO lending.

From a supervisory standpoint, the FDIC's policy is to list concentrations of credit that exceed 25 percent of a bank's capital in our examination reports. We consider LBOs to be a concentration category. Aggregating all LBO transactions together as a concentration in an institution has analytical merit because high leverage entails high risk. However, there also are mitigating factors. LBOs are scattered among many industries that respond differently to economic cycles. Risk is also diversified by holding small pieces of numerous deals rather than concentrating exposure in a few transactions.

The listing of such concentrations in reports of examination, therefore, is primarily informational and the degree of any criticism accorded such a concentration will depend on several factors. Those factors include the diversification within the LBO portfolio, the quality of the individual credits, management's expertise, the bank's policies and internal controls, management's demonstrated ability to conduct independent credit analysis of each deal and the capital and earnings capacity of the bank.

Banks that do not have the expertise to conduct in-house independent credit analyses of LBOs should not be engaging in or buying participations in such transactions. This pertains to the vast majority of small banks and some regional banks. Potential purchasers must not rely on the seller to perform the analysis for them -- especially because sales are made without recourse.

Our interest in LBOs is not limited to just the banks we supervise (*i.e.*, state-chartered banks that are not members of the Federal Reserve System), but extends to all banks insured by the FDIC. Several years ago, for example, the federal and state bank supervisory agencies adopted a "Uniform Agreement on the Classification of Assets and Appraisal of Securities." It was reaffirmed as recently as 1979. This policy effectively dissuades all insured banks from acquiring subinvestment quality securities since securities rated below the top four rating bands by a nationally recognized rating service (or unrated securities of equivalent quality) are classified as substandard assets. "Junk bonds," as we know them, fall within the subinvestment quality definition and therefore are criticized if acquired by FDIC-insured banks. Consequently, almost no "junk bonds" are held by FDIC-insured institutions.

We believe that LBO lending requires more than the minimum amount of capital protection. We expect any FDIC-insured bank with a significant exposure in LBO loans to operate with a correspondingly higher level of capital. We also expect these banks to provide loan loss reserves that adequately recognize the additional portfolio risk inherent in highly leveraged financings.

In addition to our individual attention to LBO activity, we also will be involved in cooperative efforts with the Office of the Comptroller of the Currency and the Federal Reserve Board in learning more about LBO lending. During 1989 we will participate with those agencies in the examinations of several multinational and large regional banks. Part of that effort will be to ascertain which banks are purchasing LBO loans from originating banks, particularly if the buyers are regional and community banks. We want to monitor what credit and documentation information is provided to the participating banks, and what type of loan analyses those banks perform.

The vast majority of LBO credits fall within what the three federal bank regulators call the "Shared National Credit" ("SNC") program. These are credits of $20 million or greater that are shared by two or more banks. The credits are examined and classified in the spring of each year by special, highly qualified interagency teams of examiners to ensure that the loan is treated the same way at each participating institution. At the upcoming SNC examinations, we will focus more closely on LBO lending. Examiners will receive specialized training at the commencement of the examinations. The purposes of all loans will be clearly highlighted so that HLTs can be readily flagged and totaled on a nationwide basis.

CONCLUSION

Our information at this time is that banks are managing their LBO financing risks prudently. We do not now perceive any serious threat posed by such financing to the banking industry. However, we will continue to monitor the situation closely.

For the U.S. economy, the risk of increasing debt is clearly rising too rapidly.

Chairman ROSTENKOWSKI. Thank you. Ms. Utgoff.

STATEMENT OF KATHLEEN P. UTGOFF, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION

Ms. UTGOFF. I am delighted to be here, especially since this is the first time I have been before you without discussing the financial woes of the PBGC. Because of the changes in law under the Pension Protection Act of 1987, which this committee was instrumental in passing, the Pension Benefit Guaranty Corporation, PBGC, is in much better financial condition than it was a few years ago.

The PBGC insures defined benefit pension plans and it is these pension plans that have become involved in the controversy over mergers, acquisitions and the debt structure of corporations. The enormous amount of capital invested in pension funds and involvement of defined benefit pension plans in LBO's has led to several concerns.

The first issue concerns pensions as owners of assets involved in takeover activity. The Department of Labor's Pension and Welfare Benefits Administration regulates the investment and fiduciary aspects of pension funds and will be appearing before you during these hearings.

Pension plans own stocks and bonds of takeover targets. They invest in LBO funds as well as high-risk bonds that may or may not be related to takeovers. These LBO investments and high-risk bonds, as part of a prudently managed, diversified portfolio, do not represent risk to workers, retirees, or the PBGC.

Under current law, pension funds may include other investments that carry higher levels of risk than takeover-related investments, such as venture capital and real estate investments. Only a small percentage of total pension assets are invested in the bonds and LBO funds that are being discussed here today. LBO's would go on without pension capital and, on net, pension plans as investors probably benefit from the greater returns and increased stock values that result from LBO's.

The second issue is whether surplus pension assets play a role in takeovers. Do these so-called "excess assets" increase the possibility that a company will be targeted for a takeover or LBO? Are surplus assets used to finance or fend off takeovers? Are LBO's stimulating the termination of plans in order to remove surplus assets from pension plans?

When LBO's and surplus assets were a relatively new phenomenon, there were instances where surplus assets may have played a role in takeovers. I believe that the market now generally recognizes that surplus pension assets increase the attractiveness of a company and the value of those assets is reflected in the stock prices of the company when it is a takeover target.

In effect, the purchasers of companies with overfunded plans pay for the surplus assets. As long as stock prices fully reflect pension assets, surplus pension assets cannot cause LBO's.

Current data suggest that surplus pension assets are not a significant cause of, or source of capital for, LBO activity. The PBGC reviewed all reversions greater than $100 million. In only 2 of the 30 cases was the company involved in an LBO. An additional 4 of the

30 were involved in a takeover. These results are generally consistent with other studies.

One recent study, which is not conclusive, indicates that at most 7 percent of reversions over $1 million occurred within 1 year after an LBO. The same study finds that where there is a reversion following an LBO, the amount of surplus assets is small relative to the acquisition price. Another study does find that terminations with reversions are correlated with takeovers in general.

Although the direct role of pensions in financing LBO's has received a great deal of attention, I am more concerned with the third issue, which is the effect of LBO's on companies that sponsor pension plans. Pension plans do not fail because of the investments they hold; they fail because the companies that sponsor them run into trouble. Financial distress can mean reduced funding of the pension plans and bankruptcy. These are the conditions that jeopardize pension security and the PBGC.

If highly leveraged companies are more likely to fail, then the PBGC will be asked to step in more frequently as LBO's increase. The cost to the insurance program of those failures will depend on the funding of the pension plans and how much of the underfunding the PBGC can recover as a creditor in bankruptcy.

Companies with high-debt costs are more likely to fund pension plans at minimum levels required by law and they are more likely to apply for waivers of pension contributors.

In addition, the distribution of assets to the shareholders in an LBO reduces the assets available to the PBGC as an unsecured creditor in the event of a bankruptcy. The net result of these two effects is that even if LBO's do not increase the probability that a company may fail, each failure when there has been an LBO will be more expensive for the PBGC.

My written testimony shows our concern in this case, the Kaiser case:

Kaiser Steel was involved in an LBO in 1984. Nearly $200 million was distributed to shareholders and other parties involved in the restructuring. In 1987, Kaiser filed for bankruptcy and the PBGC was forced to take over the pension plans that were underfunded by about $200 million.

The recoveries we can count on in this case are minimal, a portion of the reorganized company's stock and $1 million in cash. Kaiser simply had no assets to satisfy the claims of unsecured creditors. The PBGC was not the only loser in this case. Retirees had claims for health care promised by the company that were worth several hundred million dollars. Retirees' recoveries on these claims were less than $10 million.

Kaiser is a good example of the complexities of this problem. The LBO was certainly not Kaiser's only problem. Kaiser's steel business had already been shut down before the LBO. The problems of the steel industry are well known and the PBGC may have been forced to pay for Kaiser's pension plans in any event. Whether or not that is the case, the assets available to cover the pension underfunded would have been greater without the LBO.

The effect of the Kaiser LBO was to recover the priority of different claims against Kaiser's assets. Shareholders, usually the lowest priority creditor in bankruptcy, profited, as they often do in an

LBO. The distribution of cash to shareholders reduced the assets available to satisfy the claims of other creditors.

The effect of an LBO on the rights of different claimants has been the source of complaints from holders of bonds that were issued before an LBO. Bondholders are now beginning to put covenants in their agreements to protect their rights, which is normal market response. The PBGC and retirees do not have the same opportunities.

Let me make it clear that my concerns about the possible effects of LBO's on the government pension insurance system are not a criticism of LBO's. There is evidence to support the belief that LBO's increase the efficiency and value of a company and that pension plans can benefit from that increase in value.

But every party with a stake in a firm does not share equally in the risks and benefits of LBO's. The PBGC and other unsecured creditors may take risks without a proportionate share in the gains. This does not mean that LBO's have to be restricted to protect retiree benefits.

We can explore other solutions to make sure that the legitimate rights of all parties that have a stake in a firm are not jeopardized by new and perhaps very useful corporate financing techniques.

Thank you very much.

[The statement of Ms. Utgoff follows:]

TESTIMONY OF DR. KATHLEEN P. UTGOFF, EXECUTIVE DIRECTOR
PENSION BENEFIT GUARANTY CORPORATION (PBGC)
HOUSE WAYS AND MEANS COMMITTEE
JANUARY 31, 1989

LEVERAGED BUY-OUTS, PENSION PLANS AND THE PBGC

Thank you, Mr. Chairman, for inviting me to appear before you today. Because of the changes in law under the Pension Protection Act of 1987--which this committee was instrumental in passing--the Pension Benefit Guaranty Corporation (PBGC) is in much better financial condition than it was a few years ago. The PBGC is able to meet its commitments to the 40 million workers and retirees who depend on PBGC's pension insurance safety net. Still, the pension reforms passed in 1987 will take several years to become fully effective and a changing and dynamic economy offers new challenges and risks--such as leveraged buy-outs (LBOs)--for the PBGC.

The PBGC insures defined benefit pension plans and it is these pension plans that have become involved in the controversy over mergers, acquisitions and the debt structure of corporations. The enormous amount of capital invested in pension funds and involvement of defined benefit pension plans in LBOs has led to several concerns.

--Are pension plans that invest in high-risk ("junk") bonds and LBO funds financially secure and will this investment behavior lead to losses for retirees and PBGC?

--Are well-funded plans being terminated so that surplus pension assets can be used to finance or fend off takeovers?

--Are highly leveraged companies more likely to fail and how would these failures affect pension rights and the PBGC, which insures pensions?

The first issue concerns pensions as owners of assets involved in takeover activity. The Department of Labor's Pension and Welfare Benefits Administration regulates the investment and fiduciary aspects of pension funds and will be appearing before you during these hearings. Pension plans own stocks and bonds of takeover targets. They invest in LBO funds as well as high-risk bonds that may or may not be related to takeovers. These LBO investments and high-risk bonds, as part of a prudently managed, diversified portfolio do not represent risk to workers, retirees or the PBGC. Under current law pension funds may include other investments that carry higher levels of risk than takeover-related investments--such as venture capital and real estate investments. Further, a very small percentage of total pension assets are invested in the bonds and LBO funds that are being discussed here today. LBOs would go on without pension capital. On net, pension plans as investors probably benefit from the greater returns and increased stock value that results from LBOs.

The second issue is whether surplus pension assets play a role in takeovers. Do these so-called "excess assets" increase the possibility that a company will be targeted for a takeover or LBO? Are surplus assets used to finance or fend off takeovers? Are LBOs stimulating the termination of plans in order to remove surplus assets from pension plans?

When LBOs and surplus assets were a relatively new phenomenon, there were instances where surplus assets may have played a role in takeovers. I believe that the market now generally recognizes that surplus pension assets increase the attractiveness of a company and the value of those assets is reflected in the stock price of the company when it is a takeover target. In effect, the purchasers of companies with overfunded plans pay for the surplus assets. As long as stock prices fully reflect pension assets, surplus pension assets cannot cause LBOs.

Current data suggest that surplus pension assets are not a significant cause of, or source of capital for LBO activity. The PBGC reviewed all reversions greater than $100 million. In only two of the thirty cases was the company involved in an LBO. An additional four of the 30 were involved in a takeover. These results are generally consistent with other studies. One recent study, which is not conclusive, indicates that at most 7 percent of reversions over $1 million occurred within 1 year after an LBO. The same study finds that where there is a reversion following an LBO the amount of surplus assets is small relative to the acquisition price. Another study does find that terminations with reversions are correlated with takeovers in general. But the author does not conclude that takeovers cause terminations with reversions. Financial stress is probably the most important cause of plan termination. The correlation between takeovers and reversions may reflect the fact that takeover targets are also more likely to be firms experiencing financial stress.

In sum, there is little evidence to date that pension fund assets are either the culprit or the victim of LBO activity. This does not mean that there are no examples of pension involvement in corporate takeover battles or that new data will not identify problem areas. LBOs do not seem to be causing reversions and even when they are involved they are not a large source of capital. We are, however, continuing to research the role of reversions in LBOs.

Although the direct role of pensions in financing LBOs has received a great deal of attention, I am more concerned with the third issue, which is the effect of LBOs on companies that sponsor pension plans. Pension plans do not fail because of the investments they hold; they fail because the companies that sponsor them run into trouble. Financial distress can mean reduced funding of the pension plans and bankruptcy. These are the conditions that jeopardize pension security and the PBGC.

If highly-leveraged companies are more likely to fail, then the PBGC will be asked to step in more frequently as LBOs increase. The cost to the insurance program of those failures will depend on the funding of the pension plans and how much of the underfunding the PBGC can recover as a creditor in bankruptcy. Companies with high debt costs are more likely to fund pension plans at minimum levels required by law and they are more likely to apply for waivers of pension contributions. In addition, the distribution of assets to the shareholders in an LBO reduces the assets available to the PBGC as an unsecured creditor in the event of a bankruptcy. The net result of these two effects is that even if LBOs do not increase the probability that a company may fail, each failure when there has been an LBO, may be more expensive for the PBGC.

Let me discuss a case at the PBGC which illustrates our concerns over this issue:

Kaiser Steel was involved in an LBO in 1984. Nearly $200 million was distributed to shareholders and other parties involved in the restructuring. In 1987 Kaiser filed for bankruptcy and the PBGC was forced to take over the pension plans that were underfunded by about $200 million. The recoveries we can count on in this case are minimal--a portion of the reorganized company's stock and $1 million in cash. Kaiser simply had no assets to satisfy the claims of unsecured creditors. The PBGC was not the only loser in this case. Retirees had claims for health care promised by the Company that were worth several hundred million dollars. Retirees' recoveries on these claims were less than $10 million.

This case is not over. Lawsuits have been filed against virtually all the participants in the 1984 LBO. The retirees and the PBGC may recover something from the lawsuits but recovery amounts are speculative.

Kaiser is a good example of the complexities of this problem. The LBO was certainly not Kaiser's only problem. Kaiser's steel business had already been shutdown before the LBO. The problems of the steel industry are well known and the PBGC may have been forced to pay for Kaiser's pension plans in any event. Whether or not that is the case, the assets available to cover the pension underfunding would have been greater without the LBO.

The effect of the Kaiser LBO was to reorder the priority of different claims against Kaiser's assets. Shareholders, usually the lowest priority creditor in bankruptcy, profited--as they often do in an LBO. The distribution of cash to shareholders reduced the assets available to satisfy the claims of creditors. The effect of an LBO on the rights of different claimants has been the source of complaints from holders of bonds that were issued before an LBO. Bondholders are now beginning to put covenants in their agreements to protect their rights--a normal market response. The PBGC and retirees do not have the same opportunities.

Let me make it clear that my concerns about the possible effects of LBOs on the government pension insurance system are not a criticism of LBOs. There is evidence to support the belief that LBOs increase the efficiency and value of a company and that pension plans can benefit from that increase in value. But every party with a stake in a firm does not share equally in the risks and benefits of LBOs. The PBGC and other unsecured creditors, for example retirees with unfunded health benefits, may take risks without a proportionate share in the gains. This does not mean that LBOs have to be restricted to protect retiree benefits. We can explore other solutions to make sure that the legitimate rights of all parties that have a stake in a firm are not jeopardized by new and perhaps very useful corporate financing techniques.

Chairman ROSTENKOWSKI. Thank you, Ms. Utgoff.

For the benefit of the panel, I would like this to be a conversational thing, but I don't want any member to dominate. We are going to go through the 5-minute rule, but I would like to recognize people for the purposes of dialog that could be useful.

So, if there is something that another panel member is saying that you think you could embellish on, please feel free to do so.

Mr. Seidman, as you know, Congress recently provided special tax relief expiring in December 1989, with respect to assistance payments received from the FDIC and for operating losses arising from certain FDIC-assisted transactions.

Some of the regulators at the Federal Home Loan Bank made extensive use of these tax benefits last December, and this committee will be looking at the thrift issues next month. Can you tell me about your experience with computing and administering these tax subsidies and specific bank transactions?

Mr. SEIDMAN. Well, they just began for us in January, Mr. Chairman. So our experience is limited to this last month. However, we will be dealing with it by having the purchaser give us their evaluation of what they paid for tax benefits.

In other words, how much our cost was reduced by their getting a tax benefit, and we have been out telling purchasers how the system works. Therefore, I would think that with a few more months' experience, we will be able to give you a pretty good number.

Chairman ROSTENKOWSKI. That is what I was going to get to. Could you please send us a summary of the transactions which have utilized these tax provisions? I think that will be most helpful to us.

Mr. SEIDMAN. Yes, sir.

[The following was subsequently received:]

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington DC 20429

OFFICE OF THE CHAIRMAN

February 17, 1989

Dear Mr. Chairman:

During my recent testimony before your Committee you requested that the FDIC report to the Committee concerning the effect on FDIC assistance costs of the failing bank tax provisions enacted as part of the Technical and Miscellaneous Revenue Act of 1988. We are presently gaining experience on which to base our report.

In order to permit the FDIC to gather sufficient experience to make reporting meaningful I would propose to report to you and your Committee concerning our experience for the period ending June 30, 1989. Please let me know if you have any concerns with respect to this approach.

I look forward to appearing before your Committee on February 22 to discuss the savings and loan situation.

With best wishes.

Sincerely,

L. Wm Seidman

L. William Seidman
Chairman

Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives
Washington, D.C. 20515

Chairman **Rostenkowski**. Mr. Ruder, you stated that one economic policy issue raised by the recent proliferation of leveraged buyouts is the extent to which the existing Tax Code which could encourage corporate debt. What would be your view of a legislative proposal to reduce the difference in tax treatment of debt and equity?

Mr. **Ruder**. Sir, my view is that that difference should be reduced, and indeed, I would favor having it eliminated. I would eliminate the distinction because I believe it would give greater flexibility to management in deciding whether to use debt or equity in the management of their corporations. If corporations don't have to pay tax on the dividends, they will have greater flexibility in management.

Second, I think this change would put us in a more competitive position with foreigners. But I must say that my view is not quite as strong as some others that this change would have a great deal of effect on the leveraged buyout phenomenon. I think it would dampen it, but I don't think it is a solution that would cause this phenomenon to go away.

Chairman **Rostenkowski**. Are there any specific issues regarding securities regulation that we should keep in mind, Mr. Ruder?

Mr. **Ruder**. Most of the things that the Commission is concerned with here are to do with disclosure and conflict of interest issues.

But I think that as a tax committee you ought to be careful in imposing additional tax burdens on LBO transactions, because the impact of such taxes is unclear. My own opinion is that there should not be a rush to identify LBO's as being bad. We are not really sure what the effects of LBO transactions will be on corporate America.

I have had some of the people who are engaged in this phenomenon come in to talk to me about it, and they report that in many of their transactions, management is leaner and tougher and better in the new corporations which survived the restructuring.

There is probably one other aspect of LBO's that should be kept in mind, and that is that this phenomenon in the United States may merely be an undoing of the so-called conglomeration phenomenon of the sixties and seventies.

The market is telling us that perhaps some of those deals weren't very good, and they need to be changed. So I am not nearly as concerned that the LBO phenomenon presents a problem, primarily because I am not sure about the outcome.

Chairman **Rostenkowski**. Mr. Archer?

Mr. **Archer**. Thank you.

Mr. Ruder, is there any evidence, any studies which show that the LBO's have reduced the available pool of equity capital in the United States?

Mr. **Ruder**. There are some studies that show that the amount of equity capital in the United States has been reduced during the last several years. But I know of no——

Mr. **Archer**. Is there any connection to the LBO's that have been determined by these studies?

Mr. **Ruder**. As corporate debt has increased and net corporate equity has decreased, I would find some correlation. I don't think there is any evidence that there is lack of equity capital for investment in this country, though.

Mr. ARCHER. I am curious because the thrust of these hearings is that the deductibility of interest for tax purposes is the culprit in precipitating the amount of LBO's that we have had. I am curious about that, and I would like to hear comments on that as to why that might be.

Certainly, the tax advantage of the deductibility of interest is far less than it was prior to 1986. Certainly the double taxation of corporate earnings is less today than it was prior to 1986 because of the reduced rate. Why is it that all of a sudden, the deductibility of interest is receiving the accusation of causing LBO's? Why didn't we have far more LBO's prior to 1986 when there was a bigger advantage to the deductibility of interest and a higher rate of taxation, a double taxation rate on corporate dividends?

Mr. RUDER. I would be glad to take a try at that. I think that the reason that the LBO market has increased has been because of the creation of so-called junk bonds. We have had a junk bond market created in the United States which provides an opportunity for placement of so-called mezzanine debt.

In most of these transactions, you have approximately 50 percent of the transaction in bank debt, approximately 40 percent in high-yield bonds, and 10 percent in equity. The existence of this new junk bond market has tended, I think, to be the primary reason why these restructuring transactions have gone forward.

Mr. DORGAN. Mr. Archer, would you yield? I think you asked an excellent question. The Treasury Secretary suggested that the imbalance between equity and debt is what is driving the LBO's. Your point was as the incentive has been reduced vis-a-vis that imbalance, the number of LBO's has mushroomed.

So, I disagreed with what the Treasury Secretary said, and I agree with Mr. Ruder's response, and think your question is right on point.

Mr. ARCHER. Again, I think your answer also to some degree begs the question, because the opportunity for what you call junk bonds existed pre-1986. There was no prohibition against what you call junk bonds prior to the 1986 act. There is no change in the authorization for people who issue junk bonds. There has to be another reason.

Mr. RUDER. Sir, if I may expand that answer. Prior to the middle eighties, there wasn't the ability to place these high-yield bonds in the market.

Mr. ARCHER. Legally, it was prohibited?

Mr. RUDER. Not prohibited.

Mr. ARCHER. Why is the reason that the junk bond market came into being? It was not the change in the Tax Code.

Mr. RUDER. It is widely attributed to be the actions of Drexel Burnham Lambert where as a financing tool, these high-yield bonds were placed with a large number of institutional investors. More recently, that market has expanded so that it is not only a Drexel Burnham market, but a market which is participated in by other lenders.

I believe the emergence of the junk bond market together with the tax advantages of debt financing have made the LBO phenomenon surive.

Mr. ARCHER. But there has to be some reason why this marketing tool has developed at this time, and that reason must be something other than the question of deductibility of interest, the value of the deductibility of interest, and you have yet to give me that causal reason.

Mr. RUDER. I have given you my reason——

Mr. ARCHER. You have told me about the effect, which is that there is a market today for it, but you have not told me what caused that market to occur.

Mr. RUDER. The market attributes it to the brilliance of the person who invented it.

Mr. ARCHER. The creativity of Wall Street existed back in the early eighties or in the early seventies. There has to be something else that has happened that we haven't focused on before this committee today other than this question of a relationship——

Mr. MOODY. Would the gentleman yield?

Mr. DORGAN. Would the gentleman yield?

Mr. DOWNEY. I was going to suggest that we have already had more than 3½ hours of hearing, and the name of Michael Milliken hasn't arisen yet, who is one of the prime generators of this mezzanine market for debt; isn't that right, Mr. Ruder?

Mr. RUDER. That is the person to whom this market is generally attributed.

Mr. SEIDMAN. Could I comment?

Chairman ROSTENKOWSKI. Move the microphone closer.

Mr. SEIDMAN. Back in my days, they were called shoe-string purchases. It goes in cycles, but what has happened is that the underlying values of many corporations are worth more in parts than in the whole.

The question of how you do it is that debt has an advantage over equity. So, when you are looking at these transactions, the reason that they are being done is underlying values, willingness to take risks, Mr. Milliken and all those things, but the reason they are being done in debt is because they have a tax advantage.

If they didn't have that tax advantage, then they would be done with equity.

Chairman ROSTENKOWSKI. Mr. Pickle?

Mr. PICKLE. Thank you, Mr. Chairman.

Dr. Utgoff, we will hear you in front of our subcommittee on pensions, but let me ask you some general questions at this point. Has the PBGC made any comprehensive analysis of the participation of pension plans in financing leveraged buyouts? Have you made any deep analysis of this question?

Ms. UTGOFF. Yes, some of that. I would not call it comprehensive, but we have looked at the top LBO's, the top underfunded pension plans, and we have looked at the top reversions to see how all these things are related.

And in general, what we have found out is that the relationship between LBO's and reversions is very small, and when they are related, the amount of money involved in the pension plan is very small relative to the acquisition price of the company.

Mr. PICKLE. You haven't made any analyses? You are beginning to look at it and beginning to make an analysis of the overall question. Now, what percentage of total does the PBGC estimate are used in leveraged buyouts? What percentage?

Ms. UTGOFF. Well, specifically, how much—are you talking about surplus assets or the amount of money in a pension plan?

Mr. PICKLE. Overall, in general.

Ms. UTGOFF. The amount of pension assets that can be attributed to all of junk bonds and only some of those are LBO's is 1 percent.

Mr. PICKLE. Is that too high or low?

Ms. UTGOFF. There is no indication that it is in any way too high.

Mr. PICKLE. You don't know whether 3 or 10 percent would be too much?

Ms. UTGOFF. Let me just say that when people look at pension plan investment outside of this issue, the one question they ask is why do pension plans seem to be so risk averse? We don't have any indication that pension plans take too much risk. In fact, we have indications to the contrary.

Mr. PICKLE. With respect to individually—individual pension plans, have you made an analysis of that as a part of a company's portfolio? Do you look at it and say, this is too risky, or not too risky?

Ms. UTGOFF. No, we do not. But we have no indication that pension plans are taking on too much risk.

Mr. PICKLE. All right. Now, let me ask you another question. Is there any correlation between a leveraged buyout transaction and the subsequent termination of a company's pension plan?

Ms. UTGOFF. We have looked at leveraged buyouts—the top 25 leveraged buyouts, but I am not sure that I can answer the exact question you have asked. When looking at the top LBO's we were interested in seeing if the pensions are underfunded so that they pose a risk to the PBGC. What we have found out is that the pensions of companies involved in leveraged buyouts are distributed approximately like every other company, some are underfunded and some are overfunded.

Mr. PICKLE. I understand of these 25 different companies, some three or four are?

Ms. UTGOFF. That is right. Twenty percent.

Mr. PICKLE. Have any companies acquired through a leveraged buyout subsequent terminated underfunded pension plan?

Ms. UTGOFF. Yes. The example that I gave in my testimony was Kaiser. And that was a very large loss for us, and it was a very troublesome case.

Mr. PICKLE. What was the size of that?

Ms. UTGOFF. $200 million. The pension plan was underfunded by $200 million, and we lost all of that.

Mr. PICKLE. Well, now, is the PBGC suing?

Ms. UTGOFF. Yes. Well, as a creditor in bankruptcy we became owners of an equity share in the reorganized company. The reorganized company is suing a number of parties to reclaim on what are called fraudulent conveyance claims for previous actions; and so, yes, we are.

Mr. PICKLE. I am told pension funds constitute some 15 percent of the capital currently invested in LBO's.

Now, all things being rosy and smooth, there is no problem, but is that too much or too little?

Now, on page 5 of your testimony, Doctor, you said that there is little evidence to date that pension fund assets are either the culprit or the victim. I thought that was a little surprising. You just don't have enough data on it. Isn't your big problem that as long as junk bonds are being sold and everything is running along in an expanded economy, we hold on and say there is no storm brewing, but in case of a recession—and there will be a recession, it is coming—then you have to say, what will happen to your pension fund?

So, your fear, really, is what happens when the economic situation gets tight, and that is what we have to keep our eye on.

Ms. UTGOFF. The worries that I expressed are not over pensions as owners of assets. We really see no risk poised from that part of pension activity. I am concerned with companies that own pension plans. If they fail, that is the risk to pension plans, and that is the risk to PBGC. I am not concerned with pension plans as owners of LBO assets.

Mr. PICKLE. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Jenkins.

Mr. JENKINS. Thank you, Mr. Chairman.

You have a $200 million loss in the Kaiser transaction that you mentioned, which is a sizable loss.

Ms. UTGOFF. Yes.

Mr. JENKINS. Before your transaction, did you have a lien upon the assets?

Ms. UTGOFF. No.

Mr. JENKINS. Were you in a superior position as far as bankruptcy of that company?

Ms. UTGOFF. No.

Mr. JENKINS. So, you would not have come ahead of the stock or shareholders, anyway?

Ms. UTGOFF. The problem with what happened in Kaiser is basically the shareholders were given cash before the company entered bankruptcy. There was very little to distribute to the creditors, basically the PBGC, when the company entered bankruptcy. Shareholders, the people that are normally below us in the chain of creditors, were distributed assets, so they went away happy. The next people in line—the PBGC and retirees with health claims—had really nothing to claim.

Mr. JENKINS. So, you retained your position, but the shareholders had taken over all of the cash?

Ms. UTGOFF. That is exactly right.

Mr. JENKINS. It sounds like a good deal to me to the shareholders.

Ms. UTGOFF. That is why there are so many suits in this case.

Mr. JENKINS. Do you have legal authority to intervene under existing law?

Ms. UTGOFF. One of the nice things that happened when the Pension Protection Act was passed is that we now have more protections for that kind of scenario that I described. When a pension plan becomes very underfunded, an automatic lien can arise. The pension plans are required to have higher levels of funding. We do have more protection in a situation like that.

I can't estimate how much we would have lost in a Kaiser case under current law. It would have been substantial, but less.

Mr. **Jenkins**. But you have existing authority to protect the agency's assets under existing law in that type of a situation today?

Ms. **Utgoff**. Not completely. We have better protection. We are still basically an undersecured creditor—basically, we are between debt holders and shareholders. So any time basically you convert shareholders into debt holders through an LBO we are last in line.

So we are still threatened by an LBO activity, though to some extent the threat is reduced by the 1987 pension reforms.

Mr. **Jenkins**. Basically, when an LBO occurs, you have a group that pays off the shareholders?

Ms. **Utgoff**. That is right.

Mr. **Jenkins**. And your position as a creditor is eliminated?

Ms. **Utgoff**. That is right.

Mr. **Jenkins**. And you can't prevent that under existing law, even though you are placed in jeopardy.

Ms. **Utgoff**. Yes. It depends on the underfunding in pension plan. At the end of 1987, the Pension Protection Plan changed the laws for funding pension plans to bring grossly underfunded pension plans up to reasonably sound levels of funding over the next 15 or 20 years.

As that time passes, the threat that is posed by LBO's to us will become less and less. It is still there right now. But the Pension Protection Act really played a very important role in giving us more authority and reducing the risks.

Mr. **Jenkins**. Are you trying to hold the directors of the company personally liable on this transaction?

Ms. **Utgoff**. There is a suit against the directors of the company.

Mr. **Jenkins**. Moving to another area, I am concerned about the manner in which we attempt to restructure, if we try to put a prohibition or an elimination of deductibility of interest as a business deduction in the event that Congress and the administration decide to go in that direction, and if we shift over to the equity side—that is in my example to the Secretary earlier—if we place, say, 80 percent of interest deductible, take that 20 percent in revenues and eliminate a portion of the disparity with the dividend's nondeductibility, would we end up increasing the cost of capital to a tremendous number of small business concerns, since they would take 80 percent rather than 100 percent?

Mr. Seidman? Mr. Ruder?

Mr. **Seidman**. Congressman, first, I suggested that the rate be the same on both dividends and interest so that the overall rate would be the same. Now, depending on how much credit—whether you give them a full credit or not would depend on what the cost of capital would be.

What it would certainly do would be to increase the cost of interest a little bit and decrease the cost of equity a bit. I would think that that would be desirable for more stability in the system.

Mr. **Jenkins**. You would make a distinction between operating capital versus acquisitions?

Mr. **Seidman**. No, I agree with Secretary Brady. I think it is literally almost impossible, to set up a tax system that can distinguish good interest deductions from bad interest deductions. I was a tax lawyer for many years, and I suggest that whatever you set up, I will find ways to get around.

So I don't think it is something that really is a practical solution. It will cause all kinds of litigation and will give my brethren in that business many hours of work. So I don't think it is practical.

Mr. **Jenkins**. Fifty percent or seventy percent deductibility, you would do it across the board?

Mr. **Seidman**. My view is that, in effect, the corporations withhold the tax against the individual shareholders, so they get the tax first, and let's say they withhold 35 percent against both dividends and interest. When it is paid out, then the amount is credited to the individual, and therefore, it is truly a level playing field.

Mr. **Ruder**. You are attempting to do this in a revenue-neutral way, and I think that that is just a very, very great obstacle to overcome. If you want to remove the competitive advantage for debt, it seems to me that such action likely would decrease tax revenue, and you can't do that now.

So my advice would be not to do it.

Chairman **Rostenkowski**. Mr. Vander Jagt.

Mr. **Vander Jagt**. Thank you. I would like to thank our members of the panel for being here today, and apologize that many of us, because of a prior meeting, didn't get to hear the beginning of your testimony. Mr. Seidman, you said there is a distinction between desirable LBO's and undesirable LBO's. I would like to ask you first if you can give us any guidelines for distinguishing between the desirable and undesirable?

And if we can, is there any way that we can balance the Tax Code that would prevent or discourage or stop subsidizing undesirable ones without, in the process, stopping the desirable ones?

I kind of gather from what you said about the inability to distinguish between good interest deductions and bad interest deductions that it may not be possible. But I would just like your general comments on that?

Mr. **Seidman**. That is correct, and Congressman Vander Jagt, I don't think there is a way to do that. What I may evaluate as good, someone else may evaluate as bad. How did it affect R&D, was it an entrenched management that was abusing their privileges, and so forth?

I don't know how you could write that into the Tax Code. It seems to me that if we feel that there is too much debt because of LBO's, the way to do it is to change the system so that it is just as easy to use equity as it is debt.

Mr. **Vander Jagt**. Is there possibly an area in ESOP's? You pointed out that ESOP's have become a tool, both to takeover and to defend against takeovers and ESOP's have been given some unique tax advantages. Do you think there is any adjustments in the way we treat ESOP's tax-wise that would address the problem?

Mr. **Seidman**. I would support what Secretary Brady said, that the ESOP's can be constructive if it is clear that they are truly transferring ownership and control for the employees of the firm. I think there might be some means to ensure that it takes place.

But in general, given that, I think that they can be a useful way to improve efficiency in a corporation.

Mr. **Vander Jagt**. Thank you, and I thank the other members of the panel. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Downey.

Mr. **Downey**. Thank you, Mr. Chairman. Mr. Ruder, can we go back to—I have a question. The Drexel, as I understand it, the Department of Justice, has worked out a deal where they are going to have to pay a $650 million fine for their past activities?

Mr. **Ruder**. I am not at liberty to discuss enforcement other than what is in our complaint or in our newspapers.

Mr. **Downey**. Would that be tax deductible, what they have to pay?

Mr. **Ruder**. I would have to ask my tax lawyer, Mr. Seidman. I believe it would depend on how the deal was structured.

Mr. **Downey**. Mr. Seidman, can you illuminate us on that?

Mr. **Seidman**. There is no way I would opine that and also I haven't practiced for quite a while. Thank you.

Mr. **Downey**. So since we don't know yet what the fine is and when we know, we are not sure whether it is deductible or not? Is that a fair summary of where we are today.

Mr. **Ruder**. I simply can't talk about the deal. I can't comment on it.

Mr. **Downey**. Can I ask you, because it appears to me while we are not near discussing personalities that a personality helped to create this mechanism, Mr. Milliken, and apparently to a certain extent, the market, the irony is that he is now facing extraordinary legal difficulties and everyone else is imitating his use of this mezzanine level.

How is it different, this method of financing than what existed before, applying the same lessons there to corporations that people before it applied to real estate? Any member of the panel.

Mr. **Ruder**. The technique of borrowing money in order to acquire a corporation and then using the assets of the corporation to repay the debt and restructure the company is not new. The new part of the junk bond phenomenon has been the ability to place this high yield debt with the institutional investors.

That is different from the other market, as I understand it.

Mr. **Seidman**. If I may comment, Congressman, the ability to qualify these instruments as debts so they are deductible has been perfected under Mr. Milliken's system. We, back in the old days, were always on the edge of whether when we did something, IRS would say it wasn't really debt, although we called it so.

He did a pretty good job of taking the IRS's rules and getting within what they would allow as deductible debt even though it looked a lot like equity.

Mr. **Downey**. Am I wrong in assuming that there are millions of dollars out there in pension assets yet to be distributed for this purpose? Secretary Brady and others have said it appears as though this is a shaking out process, maybe we should do nothing.

But it doesn't appear that there is any wanting of assets to continue LBO's, is there?

Ms. **Utgoff**. There are basically $2 trillion in pension plans. We find that for defined pension benefit plans that they have only a tiny percent of them invested in all kinds of what are called junk bonds. And we certainly have no indication that pension plans take on any abnormal risk.

In fact, they are quite risk averse. So I don't see anything in the numbers that we have looked at that would indicate an enormous pent-up demand for the high-risk type LBO assets.

Mr. DOWNEY. Another question. Is it the panel's collective judgment or wisdom that this process is costing the Treasury money? And I have seen some studies that suggest that we get this money back in capital gains payments and create an increased wealth. Do you have any sense whether this process is costing us money?

Mr. SEIDMAN. I really don't. I have seen studies on it, but I have not looked at it myself. It is a very complicated question.

Mr. RUDER. I can tell you what to look at. You should look at the capital gains tax on the shareholders. You should look at whatever capital gains taxes there are on asset sales when the restructured company is refinanced.

You should look at the taxability of the high interest payments on leveraged bonds. You should look at the question of what happens to the reinvested proceeds and whether the proceeds create a taxable revenue stream. And you should look at whether the restructured company becomes more profitable and throws off a taxable income stream.

If you consider all of those factors, I think, it will indicate a great deal of uncertainty about whether the tax effects are revenue neutral.

Mr. DOWNEY. I don't know that I have the time or ability to look at it and come to any conclusion. Are you looking at it or is anyone else in the Government looking at those questions to determine whether or not there is a revenue loss?

Mr. RUDER. We are not looking at that specifically. The Commission's staff is studying certain portions of it, but not with that overall approach.

Mr. DOWNEY. To your knowledge——

Chairman ROSTENKOWSKI. Mr. Guarini.

Mr. GUARINI. As I understand, junk bonds means that there are loans against the company assets without any liens or claims; is that correct?

Ms. UTGOFF. They are often backed by the assets of the company.

Mr. GUARINI. Yes, but there is no specific lien or claim on any assets, just credit of the company?

Ms. UTGOFF. They are not specifically attached to any specific assets.

Mr. GUARINI. My understanding is that pension funds should be conservatively vested. You apparently invest because there is a high interest rate.

Could you tell me what the highest interest rate is that you have gotten from leveraged buyouts for your pension fund?

Ms. UTGOFF. The PBGC does not invest at all in what would be called junk bonds or leveraged buyouts. We have regulatory authority over, and we provide pension insurance for 112,000 pension plans which do invest in those instruments.

I cannot tell you. I will try to find out what the highest interest rate is.

[The following was subsequently received:]

The PBGC does not invest in non-investment grade bonds. We have, however, consulted with private money managers who indicate that junk bond yields currently range from 200 to 600 basis points above 10 year treasury bonds (about 11 to 17 percent). Most junk bond yields range from 350 to 450 basis points above 10 year treasury bonds (12.5 to 13.5 percent).

Mr. GUARINI. But you have subordinated debt that you have been involved with? Not senior debt, but subordinated debt?

Ms. UTGOFF. The PBGC gets involved with a great deal of subordinated debt because when we get involved with a company that is all that is left.

Mr. GUARINI. Do you take the work and the opinion of the lead bank or investment company, or do you do your own work, your own study of that particular deal?

Ms. UTGOFF. Both.

Mr. GUARINI. Or because Citicorp Bank did it, we don't have to do it.

Ms. UTGOFF. We do our inside analysis and use outside experts independently.

Mr. GUARINI. So you are satisfied that every deal you do, you do your basic homework and that you evaluate each deal thoroughly and don't take the opinion of the lead bank?

Ms. UTGOFF. When we do deals, it is in the nature of a bankruptcy workout with a company terminating its pension plan. In these cases the PBGC has a bankruptcy claim and we often have to take debt in satisfaction of that claim. This is totally different than the subject of junk bonds or LBO's or other things. Our experience with debt as the Federal pension insurance company is really very different than the experience of a pension fund investing in debt.

Mr. GUARINI. But there is high risk and if there is a recession you are at greater risk. Is that correct?

Ms. UTGOFF. Yes.

Mr. GUARINI. Let me ask you, Mr. Ruder. You have regulatory authority to make a number of changes in LBO's without seeking any new legislation? Are there things that you are thinking of doing now that could address the problem without necessarily looking at the tax aspects?

Mr. RUDER. The problems, as we see them, that we can address have to do with disclosure. We are considering whether or not we should apply the same disclosure rules in all negotiated transactions that we are now applying in so-called going private transactions.

We are considering whether we should increase the issuer's disclosure obligations to bondholders at the time of the sale of bonds. We are not in any way attempting to impede LBO transactions, and I may say that is quite consistent with the congressional policies of the Williams Act, which provides the basis for the Commission's authority to regulate tender offers.

Mr. GUARINI. What about things like arbitrage and putting a cap on junk bonds and giving more notice? And in fact if there is a raid, are there other areas that you think you could minimize the impact of leveraged buyouts?

Mr. RUDER. In terms of arbitrage and putting caps on junk bonds, we would not, I believe, be inclined to regulate there. We have looked at the notice required in a hostile takeover, and we have come to the conclusion after several reviews of that that the present 20 business day period with extensions for material changes gives enough time for the target company to react to a hostile takeover.

Mr. GUARINI. What about this fairness opinion where they get paid if it succeeds and they get up to 6 percent, which is one whopping fee. Isn't there an abuse there?

Mr. RUDER. We are looking at that, at least at the question of how that is disclosed. I may say that I do not favor an opinion which is one price if the deal goes forward and another if it doesn't.

Mr. GUARINI. But can you govern the fees somehow so it is not just based on whether it goes through, but that the work that is done is paid for?

Mr. RUDER. We are not a merit regulation agency in that sense, and we would only look at the disclosure or possible misrepresentation of the way that fee was presented and let the people who are engaged in the transaction decide whether or not they want a transaction with that kind of fee.

Mr. GUARINI. Thank you, sir.

Chairman ROSTENKOWSKI. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Ms. Utgoff and gentlemen, thank you for your time. It has been good testimony. It has been interesting. The General Accounting Office prepared for me a study last year showing that foreign accounting and tax practices, especially those of Great Britain and Japan, gave foreign companies great advantages in bidding against United States firms for domestic acquisitions.

Have you or any of your staff looked at this study or have you looked at this problem or do you have any thoughts in this area? Mr. Clarke?

Mr. CLARKE. Mr. Schulze, to my knowledge we have not. That is really not something that we would have any jurisdiction over. You may know that the three U.S. bank regulatory agencies have recently joined together with our counterparts in the other G–10 countries in developing uniform capital adequacy requirements, which is a great step forward in ensuring that banks around the world are operating on the same basis. But we have not been involved in terms of tax and accounting rules.

Mr. SCHULZE. Bill.

Mr. SEIDMAN. We have not been involved in that.

Mr. RUDER. One area we are studying concerning good will accounting and tax treatment is whether foreign firms have an advantage over U.S. firms in domestic acquisitions. We are also looking with the International Accounting Standards Committee at the question of differences between U.S. and foreign standards for purposes of determining whether there is some way to harmonize accounting standards throughout the world.

That project is quite preliminary at this time.

Mr. SCHULZE. I think they are both quite important and something which will have an effect on this area as time goes on.

Mr. RUDER. If I may say, we are concerned about the interaction between good will and the business combination accounting as well.

It is an area in which our accounting treatment is much different than overseas.

Mr. SCHULZE. That was one of the main thrusts of this study. I will ask my staff to send you copies of it so you can have the advantage of it.

Ms. Utgoff, I thank you for your presentation. In your discourse with Congressman Pickle, I understood you to say that nationally about 1 percent of assets of pensions seem to be invested in so-called junk bonds; is that correct?

Ms. UTGOFF. That is correct.

Mr. SCHULZE. I understood Mr. Pickle to say that his figures were somewhere between 9 and 15 percent, and I was confused in that.

Ms. UTGOFF. I was talking about the percent of total pension assets invested in junk bonds. You can also look at another statistic which is if you look at an issue of junk bonds, how much of it has been purchased by pension institutions? Those are two different numbers.

He was talking about the latter. I was talking about the former. Pension assets can provide about 15 percent of the junk bond market because there is so much money invested in pension plans.

Mr. SCHULZE. With your 1 percent figure versus that, I have got to assume from your previous testimony that you do not see a need for us to try to protect overfunded pensions from this type of raid or grab or whatever you want to call it.

Am I reading you correctly?

Ms. UTGOFF. That is right.

Mr. SCHULZE. And you don't see an advantage to us sort of restricting the take-down of those assets for a period of time?

Ms. UTGOFF. I think there would be a disadvantage. Money is fungible. It would be hard to define the LBO activity and I would see little impact of those effects.

Mr. SCHULZE. Bill Seidman, if I may just digress for a second, Congressman Brown and I have been contemplating legislation to address the FSLIC crisis by trying to either remove or change the passive loss restrictions and especially on federally insured assets.

Have you given any thought to the 1986 act and whether there is a narrow way that we can redefine passive losses, which would help—so that the American taxpayer doesn't end up putting out all of this money?

Is there some way we can do it without zonking the taxpayer between the eyes.

Mr. SEIDMAN. I don't know that you can. If you open up the passive losses again, there will be more deductions and more tax benefits and the deficit will change accordingly. So I don't know of any way that you could do it.

Mr. SCHULZE. How about a narrow window on just assets that have been reverted?

Mr. SEIDMAN. If the window is narrow, the loss will be smaller. But the design was to give a tax benefit and that has to reduce revenues.

Chairman ROSTENKOWSKI. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Dr. Utgoff, you said that there is evidence that LBO's increase efficiency. Could you share with us that evidence?

Ms. Utgoff. We will be happy to provide the economic studies that are the basis for that conclusion. It has to do with the stock values, subsequent and prior to an LBO.

Mr. Dorgan. But that is a different issue than promoting efficiency. There are studies on whether LBO mergers promote efficiency, Louis Lowenstein, Professor Sherer and others, that draw exactly the opposite conclusion.

I am unaware of any studies that suggest that LBO's have increased the efficiencies of the companies taken over.

Ms. Utgoff. I will provide those for you.

Mr. Seidman. We could give you examples where we think that is true, not a study, but just specific examples. I just wrote a book which has them in it and I will send you a copy.

Mr. Dorgan. I appreciate that. I am not unaware that there may be exceptions, but I don't want the exception to demonstrate the rule. The only studies I am aware of would suggest that targeted companies on the whole have been companies producing above average returns just prior to the acquisition and producing below average returns after the acquisition.

But we will talk about that some more, I assume, and probably get some information from you.

Mr. Ruder, are you aware of hostile takeover activity in Japan or West Germany and if so, at what level is it?

Mr. Ruder. Virtually nonexistent in either country.

Mr. Dorgan. And why?

Mr. Ruder. Basically because both countries control the takeover activity through their banking and ownership systems.

Mr. Dorgan. Would that be because those countries believe from a public policy standpoint it is inadvisable? Probably not level from an international competition standpoint? What is your assessment on why they prevent it?

Mr. Ruder. This is pure conjecture, but I think it has to do with the way each of those economies grew after the war. In Germany you have the banks which have very strong commercial lending, and ownership and nominee situation with the various companies. In Japan, there is the strong cross-ownership that Secretary Brady talked about.

Mr. Dorgan. The point I would make with that is——

Mr. Ruder. It is not a deliberate policy, created to prevent takeovers. It is just the way the economy has grown. It doesn't put them in a situation where the takeover phenomenon can occur.

Mr. Dorgan. Culturally at least it would be difficult to convince them that that makes sense. But, from a competitive standpoint it is interesting to note that some worry about our putting our domestic corporations at a disadvantage because international corporations can come in and play the speculative game and hostile takeovers on our turf, but we would not be able to do that in Japan or West Germany because it is not allowed there.

I make that point in terms of competitiveness. I would like to ask about junk bonds, Mr. Ruder. I think you made a very important point when answering Mr. Archer's question. You responded that the vehicle that allows all of this LBO activity to happen is junk bonds. Junk bonds became the propellant that allowed them to become players.

Mr. **Ruder**. Plus the change in ownership in our society of assets. The pension fund information we have had is very very important.

Mr. **Dorgan**. That gets to my question. Is there not a willingness to accept more risk on the part of people in recent years simply because we have been through a longer period of growth. People, particularly in the pension area, are looking for greater returns so they are willing to assume slightly more risk.

With regard to the default rate on junk bonds, you made reference to the 3(a)(9) procedure in which you convert a junk bond to an equity issue. Can you give us a description of how often that has been going on? Is it something that happens a lot? Doesn't that masquerade the default rate and tend to delude those vesting in junk bonds?

Mr. **Ruder**. I cannot give you information that comes from an in-depth study, but I can give you the ad hoc information from people active in this field. They are telling me that the phenomenon of refinancing junk bonds is not very prevalent in the current market and that junk bonds are essentially being paid, either paid off completely or the debt stream is being satisfactorily financed.

We don't know what the result will be in a recession, and I think that one of the things that I would concentrate on would be the question of who are the holders of these junk bonds and what risks do they have, should we have a downturn in our economy. That is where the real risk is in these transactions because the junk bond holders are going to be in the 40 or 50 percent that underlies the bank debt. Banks, at least in my opinion, won't be as much at risk as the junk bond holders.

Chairman **Rostenkowski**. The time of the gentleman has expired.

The Chair is ready to announce to the committee that the 2 o'clock panel is ready to go. But before we do that, those members that have not asked any questions of this panel that would like to ask questions, please give me an indication by raising their hands.

OK. Thank you.

Mr. Rangel.

Mr. **Rangel**. Doctor Utgoff, it was your testimony that the pension funds represent an insignificant part of the total investment in the LBO's.

Ms. **Utgoff**. A small part.

Mr. **Rangel**. You were asked three questions in your testimony, and I am not certain what the answers are to that.

Are the pension funds that invest in LBO's financially secure, and will this investment behavior lead to the loss for retirees in PBGC?

Are you satisfied that PBGC is not exposed to any more failures than other types of funding?

Ms. **Utgoff**. The answer to that question is no, that the purchase of LBO-related investments by pension plans as asset owners does not pose a risk for the retirees or the PBGC.

We are concerned that companies that experienced an LBO and have an underfunded pension plan are more at risk. Through that mechanism we and the retirees will be more at risk.

The risk does not come from pension plans as owners of assets. Pension plans fail because the companies that sponsor them run into trouble.

We are not concerned with pensions as asset owners of LBO investments. We are concerned with companies that have experienced an LBO and whether they have a pension plan and whether that pension plan is underfunded.

Mr. **Rangel**. Is the PBGC, able to influence companies as to whether or not their pension plan is well-funded or underfunded? *Are you able to influence whether or not those pension funds are* going into investments in LBO's?

Ms. **Utgoff**. No. The investment activity of a pension plan is regulated by the Department of Labor.

Mr. **Rangel**. Can you give us the benefit of your experience as to whether or not pension plans have failed as a result of being involved in highly leveraged companies? That is where you found substantial pension benefits in underfunded programs, have they been LBO's or equity financed firms?

Ms. **Utgoff**. Underfunding is almost exclusively because employers don't put money in their pension plan. We have never been responsible for a company because of the unwise investments that it makes, short of the company putting their own stock in the pension fund because they are under financial distress. The kinds of investments that you are talking about have never caused a problem for the PPGC or for retirees.

Mr. **Rangel**. You never had a problem with the PBGC as relates to some of the firms using their pension funds as assets in order to get involved in leveraged buyouts?

Ms. **Utgoff**. No.

Mr. **Rangel**. Thank you.

Chairman **Rostenkowski**. Mr. Brown.

Mr. **Brown**. Thank you, Mr. Chairman.

I wanted to address my inquiries to Mr. Ruder, or, perhaps, other members of the panel who would care to comment.

One of the areas of the concerns that have been brought up here is that if we make it more difficult to affect the leveraged buyouts that we will, in effect, be protecting incumbent management.

Setting aside for a moment whether incumbent management is good or bad, obviously, that will vary as the company varies. I am hoping you can shed some light on how insulated, how safe incumbent management is.

For instance, I wonder if you have a feel for what portion of votes, shareholder votes are returned to management on an average basis in a proxy solicitation? Is there any indication from your shop's operations?

Mr. **Ruder**. At the Securities and Exchange Commission, it is quite clear that in a nonproxy contest situation, management will receive an overwhelming number of votes, except that in the past 4 years there has been growing evidence that institutional investors are beginning to vote their proxies in certain corporate situations, corporate governance areas, such as regarding rescission of poison pill against management.

I think the entrenched incumbent question is much better answered by determining whether management has been effective in preventing hostile takeovers.

I think, by and large, the experience in the United States has been that as hard as they try and put in new laws here and there and try new defenses, they have not been successful.

Mr. BROWN. The question is a little different for us, though. The question, I guess, for us is should we try and make it more difficult to take over companies? That hinges, I think, on the question of whether or not protecting incumbent management is a good idea.

Mr. RUDER. I have to give you the same testimony that I gave on behalf of the Commission in regard to proposed legislation to influence the tender offer situation.

We believe that the proper way to address this question is to look at the target company and its shareholders. We believe that they are the beneficiaries of these transactions.

We are not able to tell which hostile tender offers or LBOs are harmful, and which are beneficial. Since one can't tell, our strong opinion has been that one should not interfere with them.

Mr. BROWN. Some of the magazines have focused recently on the fact that United States managers of very large corporations are paid more than people in either Europe or Japan would be for similar positions.

Would you share that view, or would you have a different view of compensation levels for corporate executives?

Mr. RUDER. I have not made that study, and I couldn't give you an answer. My offhand guess would be in terms of cash compensation, probably; yes.

Mr. BROWN. I wonder if any other members of the panel would have comments on the advisability of insulating the incumbent management?

Mr. SEIDMAN. I don't think they should be protected. What I was addressing is that if we neutralized dividends and interest, then they could accomplish the transactions, and build the debt levels up to high-risk positions for the economy and for the corporations.

If you neutralize those two, you still have the opportunity to go after the management if they can do it. But they wouldn't have to use debt.

Mr. BROWN. One of the phenomena I notice in Colorado banks, I wonder if it doesn't fit in other places of the economy, on a regular basis for the last 30 years, I say 30 years because I am aware of it during that period, individual banks have sold at a significantly higher price in relation to their book value and their earnings than have the holding company banks that are much larger operations.

In other words, a leveraged buyout of our banks would add significantly to the shareholder's interest. Is that a phenomenon of only Colorado or is that a phenomenon that perhaps exists in other places as well?

Mr. SEIDMAN. I think it is true, and is true in a number of other industries. The communications industry has long had the phenomenon that individual radio stations and televisions stations will sell for more than combined value of all of them in the holding company. There is certain value to control.

Chairman ROSTENKOWSKI. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Dr. Utgoff, I believe you testified that the level and the nature of the investments of pension funds are not such that it would warrant monitoring the riskiness of those investments?

Ms. UTGOFF. Let me just—the answer to that is yes. The pension plans are under fiduciary rules that guide their activities and ensure that investments are prudent.

There is no indication that they are not following those guidelines and that we really see no problem of this small investment in normal pension plan portfolio.

Mr. COYNE. I assume that is because of the level of investments and the nature of the investments so far? Is that correct?

Ms. UTGOFF. Yes, and also the general overall risk level engaged in by pension plans. You have to ask yourselves are pension plans just substituting this particular asset for part of what is known as a private placement or higher risk part of their portfolio?

We don't really see that the involvement of pension plans in LBO or junk bonds has increased overall risk characteristics of a particular pension plan portfolio.

Mr. COYNE. Can you envision a point at which the level and the nature of those investments would warrant a more active involvement in monitoring them?

Ms. UTGOFF. They are monitored. We do not see any indication that pension plans are taking on too much risk. As I said before, every indication when people talk about risk levels of pension plans, the usual question is why our pension plans seem to be so risk averse.

They do not seem to be engaged in high levels of risk taking. They may have a particular part of their portfolio that is slightly risky, and it is a small part.

There is no evidence to indicate pension plans are taking on unacceptable levels of risk in any parts of their portfolio.

Mr. COYNE. Thank you.

Chairman ROSTENKOWSKI. Mr. Chandler.

Mr. CHANDLER. Thank you, Mr. Chairman.

Doctor Utgoff, in your testimony you talk about the fact that you believe that in the case of a company with a pension plan that is well-funded, that fact is reflected in its stock price, that value is already discounted from whatever——

Ms. UTGOFF. Yes.

Mr. CHANDLER [continuing]. Else there might be taking place. You also say that those pension plans, those assets seem to be well-managed and reasonably well invested.

The thing that concerns me, though, is the fact that the third major statement you made, I think, is that when the companies sponsoring those plans run into difficulty, that then you begin to have problems. That is when you can have an underfunding situation begin to take place.

At that point, PBGC begins to be at much greater risk than it was before.

Ms. UTGOFF. That is a very good summary of my testimony.

Mr. CHANDLER. Wouldn't the logic follow then that if a well-funded pension or sponsor of a well-funded pension becomes the victim of a leveraged buyout, and if assets are reverted and if that company is highly leveraged, then you are in the future very much more highly at risk than you were before?

Ms. Utgoff. You are talking about a company that had an overfunded pension plan?

Mr. Chandler. May or may not. It is well funded.

Ms. Utgoff. Subsequent to an LBO what happens?

Mr. Chandler. Then because of the highly leveraged nature of the buyouts, because of the greater risk to that company, and, of course, we are just beginning to see the effects of the phenomenon. We have not had a recession. At that point then PBGC does——

Ms. Utgoff. As long as the pension plan remains well-funded or overfunded, we are at no risk.

Mr. Chandler. I understand that. We know when a company begins to get in trouble, then they are not well funded or overfunded.

Ms. Utgoff. One of the real benefits of the law that was passed in 1987 was to help make sure that companies that are already well-funded stay that way.

Our primary concern is with companies that are now underfunded and go through a leveraged buyout. We rarely deal with a company that has ever been overfunded.

The typical pension plan we take over is 40 percent funded. The typical pension plan overall is about 150 percent funded.

We are talking about two different categories of pension plans. A typical pension plan that we take over has been underfunded, and is getting in worse and worse condition as it gets closer to our intervention.

They are not in a category of an employer who wants to put extra money into their pension plan because there are tax advantages. Those are troubled employers who do not get the tax benefits because they don't pay taxes.

You are looking at troubled and nontroubled employers. That is the most important division line where we get worried. We are not too worried.

Mr. Chandler. These are companies perhaps we don't need to worry about today, but 10, 15 years from now they may be one?

Ms. Utgoff. The new pension law passed in 1987 will become much more effective. If we can get through the next 10 or 15 years, I would think this problem would be significantly reduced.

Mr. Chandler. Thank you, Mr. Chairman.

[The following questions from Congressman Coyne and the response were subsequently received:]

Questions for David S. Ruder, Chairman, SEC

From William Coyne, M.C.

You have said in the past that you believe LBOs should be "allowed to go forward, based upon the market evaluation of the environment". I believe that, if an economic market is to function efficiently, there should be perfect knowledge or at least equal access to information for all participants. Would you support legislation that increases access to information on proposed mergers and acquisitions?

One suggestion of the reason for the recent increase in the number of companies "going private" is that private companies are not subject to the reporting requirements of the SEC. Would you agree with that?

It is my understanding that, under Rule 415 of the SEC, large companies can file greatly abbreviated registrations for stock and bonds and can issue "shelf registrations" with no waiting period. Do you believe there is a relationship between the promulgation of Rule 415 and the increase in LBOs?

Do you believe that Rule 415 gives underwriters sufficient time to conduct duly diligent and current investigations of the issuing companies?

OFFICE OF
THE CHAIRMAN

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

March 27, 1989

COMMITTEE ON
RECEIVED
MAR 28 1989
WAYS AND MEANS

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Rostenkowski:

This responds to your letter of February 21, 1989, which contained a number of questions asked by Congressman Coyne in connection with the Committee's hearing of January 31, 1989. Attached for the hearing record are the Congressman's questions followed by my responses.

Sincerely yours,

David S. Ruder

David S. Ruder
Chairman

Additional Disclosure in Control Transactions

Question

You have said in the past that you believe LBOs should be "allowed to go forward, based upon the market evaluation of the environment." I believe that, if an economic market is to function efficiently, there should be perfect knowledge or at least equal access to information for all participants. Would you support legislation that increases access to information on proposed mergers and acquisitions?

Answer

The Commission currently has adequate rulemaking power to ensure disclosure of material information about merger and acquisition transactions under the statutory provisions outlined in my testimony. The federal securities laws protect investors in these transactions by mandating the disclosure of material information. Of principal significance in this context are the tender offer and merger proxy rules that are designed to provide the subject company's shareholders with information concerning the transaction in which they are asked to sell their securities.

As stated in my testimony, the Commission staff is currently reviewing Commission disclosure requirements and exploring proposals to expand or modify the scope of current rules to ensure that shareholders and other investors are receiving adequate information. Although I anticipate that any improvements to the disclosure scheme can be accomplished through existing rulemaking authority, the Commission will recommend legislation should it determine that additional authority is required. The Commission recently proposed for comment amendments to its rules to require increased disclosure concerning significant equity participants in control transactions. 1/

1/ Exchange Act Release No. 26599 (March 13, 1989) [54 FR 10360].

Increase in Going Private Transactions

Question

One suggestion of the reason for the recent increase in the number of companies "going private" is that private companies are not subject to the reporting requirements of the SEC. Would you agree with that?

Answer

Although the cost savings and increased flexibility in operating the corporation that accompany the elimination of the obligation to file periodic reports with the Commission and other legal obligations incurred by a public company are often important considerations in going private transactions, 1/ I do not believe that the termination or suspension of reporting obligations under the Exchange Act is the reason for the increase in going private transactions. That motivation for taking a company private has always existed and, therefore, is unlikely to account for an increase in this type of transaction.

1/ See 17 CFR § 240.13e-100, Items 5(f) and 7(a); 17 CFR § 240.13e-101, Item 3(a) and (i); and 17 CFR 14d-100, Item 5. See also Langevoort, Information Technology and the Structure of Securities Regulation, 98 Harv. L. Rev. 747, 754 (1985).

Shelf Registrations and LBOs

Question

It is my understanding that, under Rule 415 of the SEC, large companies can file greatly abbreviated registrations for stock and bonds and can issue "shelf registrations" with no waiting period. Do you believe there is a relationship between the promulgation of Rule 415 and an increase in LBOs?

Answer

Those provisions of Rule 415 that allow for "at the market" offerings do not facilitate the use of a shelf registration for LBO transactions for several reasons. First, if securities are registered in anticipation of future acquisitions by the filer, a post-effective amendment to the registration statement would have to be filed at the time a target is identified to describe the plan of distribution and provide other material information. 1/ As with the filing of an initial registration statement, sales of the securities could not be made until the post-effective amendment became effective -- imposing a waiting period on the issuance of the shelf securities. Second, with respect to the registration of securities as part of a business combination transaction, the transactional filing and dissemination requirements, including the requirement of a shareholder vote, will impose waiting periods. Finally, the availability of Rule 415 for delayed offerings is restricted to "seasoned" issuers eligible to register securities on Form S-3 or F-3. 2/ Accordingly, it would not be available to the typical "shell" acquisition vehicle utilized in LBO transactions.

1/ See 17 CFR § 229.512(a).

2/ See Release 33-6499 (Nov. 17, 1983) [48 FR 52889].

In order to use Form S-3 or F-3, the issuer must have continuously filed all periodic reports for the preceding 36 months and in a timely manner for the past 12 months, and the offering must meet specified transactional requirements, including in the case of debt securities, that the debt is investment grade. If the issuer is a majority-owned subsidiary, the offering also may be registered on Form S-3 if the subsidiary itself meets the requirements for using the Form, the parent meets the requirements and the debt is investment grade, or the eligible parent guarantees the debt of the subsidiary.

Rule 415 and Due Diligence

Question

Do you believe that Rule 415 gives underwriters sufficient time to conduct duly diligent and current investigations of the issuing companies?

Answer

When Rule 415 was enacted in its final form in 1983, commentators raised concern about an underwriter's ability to conduct due diligence investigations 1/ in light of the likely fast time schedules. 2/ Although most of the information is incorporated by reference from other filings with the Commission, commentators urged that no underwriter could afford to devote the time and expense necessary to conduct a due diligence review before knowing whether it would handle an offering and that there would not be sufficient time to do so once it was selected. Underwriters would nevertheless be subject to liability under Section 11 of the Securities Act, 15 U.S.C. 77k, and other provisions of the federal securities laws for information in the prospectus and incorporated by reference. Because of these concerns, the Commission limited the use of the rule to delayed offerings qualified to be registered on Form S-3 or F-3. 3/ The Commission stated:

> [P]rocedures for conducting due diligence investigations of such registrants, including continuous due diligence by means such as designated underwriters counsel, are being adapted to the integrated disclosure system and shelf registration. The Commission believes that the widespread market following of such companies and the due diligence procedures being developed serve to address the concerns about the adequacy of disclosure and due diligence and, thus, ensure the protection of investors. 4/

1/ *See* Release 33-6499 (Nov. 17, 1983) [48 FR 52889].

2/ *Id*.

3/ Rule 415 also allows "traditional shelf offerings" that will be commenced promptly and may continue for a period in excess of 30 days. These offerings may not be feasible other than on a delayed or continuous basis.

4/ *Id*.

Underwriters have taken several steps to alleviate their concern regarding due diligence reviews for Rule 415 offerings. First, underwriters have developed "reservoirs of knowledge" about companies that may select the underwriter to distribute their securities. "Reservoirs of knowledge" consist of periodic reports under the Exchange Act, financial analysts' reports and issuer investor relations programs. 5/ Second, underwriters have developed other techniques such as the involvement in the preparation of the registrant's Form 10-K, discussions about major developments and early coordination of offerings expected during any given year. Third is the significant trend of underwriters appointing a single law firm to act as underwriters counsel. 6/ "Designation of underwriters counsel facilitates continuous due diligence by ensuring an ongoing access to the registrant on the underwriters' behalf." 7/ Finally, one commentator who has surveyed the case law following the adoption of the shelf registration system found that "over five years since the adoption of Rule 176, 8/ not one case has been reported where an underwriter has been charged under Section 11 for a 'due diligence violation' involving documents incorporated by reference." 9/ The Commission continues to monitor this area.

5/ Nicholas, "The Integrated Disclosure System and Its Impact Upon Underwriters' Due Diligence: Will Investors Be Protected?", 11 Sec. Reg. L.J. 3 (1983).

6/ See note 1, supra.

7/ Id.

8/ 17 CFR § 230.176. Rule 176 sets forth a nonexclusive list of circumstances that the Commission believes bear on reasonableness of the investigation and the determination of what constitutes a reasonable ground for belief. The rule takes into account the circumstances of incorporation by reference, while at the same time not relieving underwriters of their basic duty to investigate all information contained in the registration statement.

9/ Frerichs, Underwriter Due Diligence Within the Integrated Disclosure System - If It Isn't Broken, Don't Fix It, 16 Sec. Reg. L.J. 386 (1989).

Questions for L. William Seidman, Chairman, FDIC

From William J. Coyne, M.C.

I understand that a number of the banks that have been most active in arranging LBOs are also banks that were heavily involved in loans to LDCs. Is the FDIC concerned that these banks are overexposing themselves to very risky debt?

What is the amount of LBO-related debt that is currently held by FDIC banks? How does the present level compare to past holdings of corporate debt?

In general, does the FDIC do a risk analysis of bank portfolios?

You were quoted in the Wall Street Journal on December 13, as saying: "Those are risky loans because there's very little room for error. If we have a dip, they [the companies] won't have the money to pay off the loans. We would like to get there ahead of the situations and try to prevent losses on such loans." What do you think the FDIC can do to minimize the losses that could occur if the economy enters a recession?

Do you think it would be useful and appropriate for the federal government to regulate participation in LBOs by institutions that are federally guaranteed -- such as FDIC banks, FSLIC savings and loans, and PBGC pension plans?

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

March 28, 1989

Dear Mr. Chairman:

Thank you for your recent letter regarding leveraged buyouts and related transactions. Enclosed are responses prepared by staff to the questions posed by Congressman Coyne.

If we can be of further assistance, please let me know.

With best wishes.

Sincerely,

L. Wm Seidman

L. William Seidman
Chairman

Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives
Washington, D.C. 20515

1. I understand that a number of the banks that have been most active in arranging LBOs are also banks that were heavily involved in loans to LDCs. Is the FDIC concerned that these banks are overexposing themselves to very risky debt?

It is true that the multinational banks involved in LDC lending are also the same banks active in arranging LBOs. However, the degree of exposure between the two types of lending varies considerably. LDC lending comprised well over 100 percent of combined equity at the multinationals during the peak period in the early 1980s. This level however has been significantly reduced since 1987. LBO loans at ten multinationals, as of September 30, 1988, represent only 4.4 percent of the book value of the loans in these institutions and 61.8 percent of the combined equity of these banks. This LBO concentration is relatively high but the exposure is relatively stable as the banks are selling significant portions of these loans shortly after origination.

Credit quality becomes especially relevant when a concentration of risk assets exceeds 25 percent of a bank's capital. Because LBO loans now average over 50 percent of the equity capital of at least the ten largest multinational banks, the FDIC is paying particular attention to the credit quality of LBO lending, as we do with any concentration at this level. However, there are mitigating factors that lessen our concern and account for our belief that the banks are not overexposing themselves. LBOs are scattered among many industries that respond differently to economic cycles. Risk is also diversified by holding small pieces of numerous deals, generally no more than $50 million to one borrower, rather than concentrating exposure in a few transactions. Likewise, LDC debt is diversified among various countries. It is supported in many ways by various government programs.

Both LDC and LBO debt warrant and receive special supervisory attention, but at this time we are not overly concerned about the combined exposure in our major banks.

2. What is the amount of LBO-related debt that is currently held by FDIC banks? How does the present level compare to past holdings of corporate debt?

Presently commercial bank financial reports do not make a distinction between LBO and other kinds of corporate lending. Consequently, the FDIC does not have precise data concerning the total volume of LBO-related debt currently held by FDIC insured banks. However, data regarding the dollar volume of LBO-related debt will be gathered during the 1989 "Shared National Credit" (SNC) examinations. These are credits of $20 million or greater that are shared by two or more banks and include most of the volume of LBO loans. The SNC examinations will commence in the spring and results should be available by mid-year.

On an estimated basis, the Treasury Department tells us that, for 1988, the amount of corporate debt incurred through LBO activity is over $60 billion, or 3.3 percent of the debt of nonfinancial corporations. About a third of this debt is in the form of "junk bonds" while the majority is senior debt, of which a large portion is held by FDIC insured banks. The present level of LBO-related loans is much higher than past holdings since most of the transactions have occurred in the past two-years.

3. In general, does the FDIC do a risk analysis of bank portfolios?

The answer is yes. The FDIC's primary supervisory responsibility is over state nonmember banks but, as the insurer of deposits in all banks, we participate as necessary in the supervision of national banks and state member banks. An appraisal of lending and collection policies, the bank's adherence thereto, and the evaluation of individual loans are among the most important aspects of the examination process. To a great extent, it is the quality of a bank's loan portfolio that determines the risk to depositors and to the Corporation's insurance fund. Conclusions regarding the condition of the bank and the quality of its management are weighted heavily by the examiner's findings with regard to lending practices. Emphasis on review and appraisal of the loan portfolio and its administration by bank management during examinations recognizes, first, that loans comprise a major portion of the asset structures of most banks and, second, that it is the asset category which ordinarily presents the greatest credit risk and, therefore, potential loss exposure to banks. Moreover, pressure for increased profitability, liquidity considerations, and a vastly more complex society have produced many innovations in credit instruments and approaches to lending. Loans, particularly those related to LBO transactions, have become much more complex. As mentioned previously, most LBO-related credits fall within the SNC program. The credits are examined and classified annually by special, highly qualified interagency teams of examiners to ensure that the loans receive the best credit analysis possible and are treated the same way at each participating institution.

4. You were quoted in the Wall Street Journal on December 13, as saying: "Those are risky loans because there's very little room for error. If we have a dip, they [the companies] won't have the money to pay off the loans. We would like to get there ahead of the situations and try to prevent losses on such loans." What do you think the FDIC can do to minimize the losses that could occur if the economy enters a recession?

Through vigilant supervision and close monitoring we think that losses that do occur can be minimized. We have been following developments in LBO lending for several years. Examination guidelines pertaining to evaluation of LBO loans were distributed to examiners in 1984. The discussion of LBO financing in our Manual of Examination Policies has been updated twice since 1986. We have surveyed our Regions to determine the extent of LBO exposure in the banks we supervise and will do so again this year. We will soon distribute additional guidelines to help examiners and bankers evaluate the adequacy of bank policies, procedures and controls relative to LBO lending.

In addition to our individual attention to LBO activity, we also will be involved in cooperative efforts with the Office of the Comptroller of the Currency and the Federal Reserve Board in learning more about LBO lending. During 1989 we will participate with those agencies in the examinations of several multinational and large regional banks. Part of that effort will be to ascertain which banks are purchasing LBO loans from originating banks, particularly if the buyers are regional and community banks. We want to monitor what credit and documentation information is provided to the participating banks, and what type of loan analyses those banks perform. Banks that do not have the expertise to conduct in-house independent credit analyses of LBOs should not be engaging in or buying participations in such transactions.

We believe that LBO lending requires more than the minimum amount of capital protection. We expect any FDIC-insured bank with a significant exposure in LBO loans to operate with a correspondingly higher level of capital. We also expect these banks to provide loan loss reserves that adequately recognize the additional portfolio risk inherent in highly leveraged financings.

Do you think it would be useful and appropriate for the federal government to regulate participation in LBOs by institutions that are federally guaranteed -- such as FDIC banks, FSLIC savings and Loans, and PBGC pension plans?

We do not believe that additional regulation over LBO lending is needed at FDIC insured banks at this time since these institutions are already highly regulated and closely supervised. For example, the riskiest portions of LBO transactions usually include high risk securities. Several years ago, the federal and state bank supervisory agencies adopted a "Uniform Agreement on the Classification of Assets and Appraisal of Securities." It was reaffirmed as recently as 1979. This policy effectively dissuades all insured banks from acquiring subinvestment quality securities since securities rated below the top four rating bands by a nationally recognized rating service (or unrated securities of equivalent quality) are classified as Substandard assets. "Junk bonds," as we know them, fall within the subinvestment quality definition and therefore are criticized if acquired by FDIC-insured banks. Consequently, almost no "junk bonds" are held by FDIC-insured banks.

In addition to regulations, insured banks are expected to adhere to supervisory guidelines governing highly leveraged transaction lending. Such guidelines require a comprehensive lending policy covering, in part, the purpose and use of financing; a recognition of the unique characteristics and risks associated with high levels of leverage; in-house limits on exposure for individual credits, specific industries, and the aggregate portfolio; a recognition of the need for independent credit reviews and assessments and management information systems to monitor performance; and a recognition of the need for well-defined standards and separate specific guidelines for approval and review of highly leveraged transactions.

Presently FDIC examiners are participating with examiners from the Office of the Comptroller of the Currency and the Federal Reserve System in a review of lending policies and procedures at the multinational banks. In this way we intend to closely supervise the banks that have originated most of the loans to ensure that sound policies and practices are being followed.

It is our opinion that all federally guaranteed institutions should adhere to the same supervisory standards as FDIC insured banks. To the extent that other institutions are not supervised as closely as the FDIC insured banks, they should be more tightly regulated to minimize risk.

Questions for Kathleen Utgoff, Pension Benefit Guaranty Corporation

From William J. Coyne

The Wall Street Journal quoted you on January 27, as saying: "the leveraged buyout boom will be expensive to the federal guaranty fund. Highly leveraged companies are more likely to fail and less likely to adequately fund their pension plans. In addition, leveraged buyouts that fail leave few assets to meet the companies' obligations to retired workers." What is the PBGC doing to minimize the losses that could occur if the economy enters a recession?

Do you have suggestions on what Congress can do to help minimize PBGC losses?

Do you think it would be useful and appropriate for the federal government to regulate participation in LBOs by institutions that are federally guaranteed -- such as FDIC bnaks, FSLIC savings and loans, and PBGC pension plans?

PBGC
Pension Benefit Guaranty Corporation
2020 K Street, N.W., Washington, D.C. 20006-1806

Office of the Executive Director

March 20, 1989

Ms. Diane Kirkland
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Ms. Kirkland:

Attached please find answers to the questions sent by Chairman Rostenkowski to Dr. Utgoff following up on the hearings on leveraged buyouts.

Sincerely,

Jon W. Breyfogle
Special Assistant to the
Executive Director

QUESTIONS FROM REP. COYNE ON THE LBO HEARING

QUESTION: WHAT IS THE PBGC DOING TO MINIMIZE THE LOSSES THAT COULD OCCUR IF THE ECONOMY ENTERS A RECESSION? DO YOU HAVE SUGGESTIONS ON WHAT CONGRESS COULD DO TO HELP MINIMIZE THE PBGC'S LOSSES?

ANSWER:

Changes in law under the Pension Protection Act of 1987 put PBGC in much better financial condition and will help mitigate the potential threat posed by LBOs. LBOs only pose threats to the PBGC if the company's pension plan is underfunded. The new law strengthens the funding requirements of pension plans and also provides the PBGC with new protections against company bankruptcy.

Still, even with the changes in law LBOs pose new challenges to the PBGC. One key question is whether companies that have gone through an LBO are more likely to fail during a recession. The answer may depend on whether the holders of junk bonds act like traditional bondholders or more like shareholders. Junk bond holders may be more willing to renegotiate debt service during a downturn than traditional bondholders in order to preserve their above market returns. If this were the case, companies that have been through an LBO may be no more likely to fail than less leveraged companies.

If highly-leveraged companies are more likely to fail, then the PBGC will be asked to step in more frequently as LBOs increase. The cost to the insurance program of those failures will depend on the funding of the pension plans and how much of the underfunding the PBGC can recover as a creditor in bankruptcy. The distribution of assets to the shareholders in an LBO reduces the assets available to the PBGC as an unsecured creditor in the event of a bankruptcy. The net result of these two effects is that even if LBOs do not increase the probability that a company may fail, each failure when there has been an LBO, may be more expensive for the PBGC.

The PBGC is closely monitoring LBOs to determine if they pose a significant risk to the pension insurance system. At this time we do not believe that LBOs pose an immediate risk to the PBGC or that additional legislation is necessary to protect the agency.

QUESTION: DO YOU THINK IT WOULD BE USEFUL AND APPROPRIATE FOR THE FEDERAL GOVERNMENT TO REGULATE PARTICIPATION IN LBOS BY INSTITUTIONS THAT ARE FEDERALLY GUARANTEED--SUCH AS FDIC BANKS, FSLIC SAVINGS AND LOANS AND PBGC PENSION PLANS?

ANSWER:

Although the PBGC cannot address the need for additional FDIC or FSLIC regulation, we can address the issue of regulating PBGC insured pension plans. Under Title I of the Employee Retirement Income Security Act of 1974 (ERISA) the Department of Labor's Pension and Welfare Benefits Administration regulates the investment and fiduciary aspects of pension funds. ERISA requires that pension funds be diversified and prudently managed. At this time there is no reason to believe that pension funds are too heavily invested in junk bond or other LBO-related investments.

Under current law pension funds may include other investments that carry higher levels of risk than takeover-related investments--such as venture capital and real estate investments. Further, a very small percentage of total pension assets are invested in the bonds and LBO funds that are being discussed here today. On net, pension plans as investors probably benefit from the greater returns and increased stock value that result from LBOs.

Chairman ROSTENKOWSKI. Thank you very much.

I ask to approach the witness stand Mr. Felix G. Rohatyn, Dr. Martin Feldstein, and Dr. Benjamin M. Friedman.

Welcome to the committee, gentlemen.

Certainly you are no strangers to the routine here at the Ways and Means Committee. I want to express my personal gratitude to all of you for joining us. I know that your schedules are filled.

But the fact that you have given us an opportunity to have an exchange with you, I am sure, is going to be very rewarding in the future.

You all know that we have been in session on this particular item since 10 o'clock this morning.

I am just hoping that you are aware that the committee is quite cognizant of the fact that this is a very sensitive area; that what we here in the Ways and Means Committee will do could certainly have an effect, whether it is a ripple or a tidal wave effect, on what happens in the economy.

Having said that, would you begin your testimony. Of course, we will go from you, Mr. Rohatyn, to Dr. Feldstein and then Dr. Friedman.

Then we will get everyone into a discussion.

Mr. Rohatyn.

STATEMENT OF FELIX G. ROHATYN, GENERAL PARTNER, LAZARD FRERES & CO., NEW YORK, NY

Mr. ROHATYN. Mr. Chairman, it is a pleasure to be here. I believe it is of great importance that the Congress fully understand some of the issues which trouble our economy and signal this concern to leaders in the Government and private sector.

I do not believe that Congress can, or should, necessarily assume responsibility to solve these problems solely by legislation.

On the contrary, it is a combination of enlightened partnership between Congress, the administration and the leaders of American business and finance which can best deal with these issues and formulate public policy which serve the interests of the Nation. Of course, in this context, I believe there are specific actions the Congress can take and I will today address myself to them.

There is a growing lack of confidence in the United States in the integrity of the financial system and in the ability of our economy to maintain itself in an increasingly complex and competitive world.

This lack of confidence is more and more focused, especially since October 19, 1987, on the activities of the financial community which is viewed, by many sectors of American society, as a parasite instead of a contributing force to the growth of this country.

The recent spate of large LBO's has focused concerns on the Congress. This has occurred against a backdrop of higher and higher losses and taxpayer financed bailouts in the S&L industry; the legal problems of certain members of the financial community; and renewed questions about the soundness of the U.S. banking system. I strongly support Treasury Secretary Brady's thoughtful testimony on this issue.

The reasons for this sudden renewed interest on the part of the Congress, after a brief spurt of activity following the Boesky scandal, are a mix of economic policy concerns as well as a reflection of the highly negative public reaction generated by some of these transactions. None of this is very new.

The whole panoply of issues presently discussed has been argued about for the past several years: junk bonds; hostile versus friendly takeovers; LBO's and the impact of high leverage; the role of institutional investors; the ethics of the financial community.

What is new is the mammoth size of recent transactions—topped off by RJR Nabisco; the financial profits generated as a result; and the questions raised about the rights of bondholders in such transactions; the oldest issue of all, namely the fiduciary obligations of management to stockholders, bondholders, employees, communities, et cetera; the relationships between institutions such as pension funds and the investment vehicles which carry out takeovers and LBO's, whether friendly or not; and many others.

These are issues that are very complicated at best and not easily subject to exact quantitative analysis. In addition, they involve very large economic interests.

But what is really involved here is what shape American businesses are in—and will be in—approaching the 21st century, and our level of confidence in the quality, skills and judgment of the business and financial institutions which are the backbone of our economy.

There probably will be as many views on these issues as there will be participants in the debate. For whatever they are worth, I will set forth certain of my own views:

The argument that high levels of debt, combined with significant management ownership, hones the entrepreneurial spirit of the management and focuses their energies is questionable.

Management ownership is highly desirable; so is employee ownership, profitsharing, et cetera. But managements can be highly motivated without mountains of debt to make them more efficient. One should also remember that the companies with the best records of operating performance, as well as the best records of employee relationship, innovation and community relationships, are those with strong balance sheets, high levels of investment and high levels of R&D. They are the IBM's and the DEC's; the Pfizers and the Mercks; the Coca-Colas and the General Electrics.

Their use of leverage has increased in the last decade because economic incentives do require it; but, they have kept their levels of debt to reasonable amounts and have had no recourse to the more exotic instruments created by the junk bond market.

Over the last 5 years, more than $400 billion in equities of U.S. companies have been retired and replaced with debt. This is a distinctly American phenomenon. In most Western countries, companies are not permitted to, or severely constrained from buying in their own stock. The stripping away of equity to be replaced by debt simply cannot take place on such a scale.

This is quite different from the current use of credit in the United States which is, more often than not, geared to disinvestment rather than investment and which forces companies more and more to operate in a liquidation mode rather than in a forward-looking, aggressive new investment mode.

There are several interrelated issues which the committee should consider, since they are all related to one another. They are: leverage; takeovers; taxes; junk bonds; regulation; and financial institutions. I will briefly discuss each:

One, leverage. The judicious, even aggressive use of credit is a perfectly normal and acceptable business strategy. The issues that are troublesome at this time, and that differentiate the recent use of leverage from other times are:

A, the dramatic debt-to-equity ratios built up in many takeovers, restructuring the LBO's. Ratios of 90–10 debt-to-equity, or higher are not uncommon. In addition, what counts as equity often consists of subordinated debt or preferred stock, with interest or dividends payable in additional paper, that further reduce the amount of real capital invested.

B, the use of significant amounts of junk bonds as part of these structures. These bonds carry interest rates ranging from 13 to 18 percent, often more than the average return on investment of the underlying business. Together with excessively heavy debt-to-equity ratio, the businesses are burdened with interest costs that are excessive in amounts and probably not sustainable through a full business cycle.

C, the fact that much of the debt is paid out to reacquire the company's own stock, or another company's stock, at a significant premium, instead of being invested in the company's own business for internal growth limits potential for future investment and growth.

Two, takeovers. It is unwise to attribute economically beneficial or harmful qualities to takeovers. Study after study has failed to show any harm at the conclusion. This is also true of their moral values. Takeovers and LBO's do have implications to our national economy, but those implications depend on the validity of the business strategy, on the soundness of their financial structure, and on the fairness to the shareholder of both the acquiring and acquired company.

The soundness of financial structures has clear implications for new investment and economic activity. It requires, in general, greater use of equity instead of debt. The taxing, as well as the regulatory system, could be used for that purpose.

The fairness to shareholders, and of the takeover process is a basic requirement to maintain healthy capital markets and individual participation. These are important national assets.

Fairness to shareholders may require differentiating management-led LBO's from other transactions. This can be done by regulatory changes or, possibly, legal changes.

Finally, massive repurchases of equities with borrowed funds should be discouraged. Many countries do not permit reacquisition of a company's own stock as a matter of law; we do not need to go so far.

But massive repurchases as part of leveraged restructurings are essentially not different from LBO's; the public provides the equity with the retention of a "stub," in lieu of the LBO house. The economics, and the related problems, are the same.

Three, taxes. The taxing system can be used to redress the present tendency to overleverage the economy, and to encourage long-term investment instead of short-swing speculation. Any time the taxing system is involved, questions of fairness, of practicality and of unexpected repercussions have to be taken into account.

The argument has been made that eliminating some or all of the deductibility of interest in highly leveraged takeover or LBO situations would help foreign companies which are not subject to such penalties. That is not necessarily the case.

Foreign companies rarely have 90-10 debt/equity ratios nor do they pay 14-16 percent interest rates for their financing. Furthermore, in many cases, foreign companies finance their acquisitions in the United State and are subject to the same tax treatment.

If we wish to put U.S. companies on a more even footing with their foreign competitors when it comes to acquisitions—and we should—it would be more important to change the accounting rules governing the write off of goodwill; that could truly be helpful.

As to taxes, leverage can be discouraged in two ways. The old "thin incorporation doctrine" suggested that debt in excess of a certain percentage of total capital was in reality equity, and that the interest thereon was a dividend, therefore, nondeductible.

Another possibility would be to suggest that junk bonds, because of their excessively high interest rates, consist in reality of an interest rate plus a liquidating return on capital.

The allowable deductible interest could be set at some relationships to the yield of an investment-rated bond of equivalent maturity. Either of these limitations could only apply to companies that had made substantial acquisitions—or reacquired substantial amounts of their own stock—within a specified period.

Such regulations would be rather cumbersome to implement, but not impossible.

Of the two alternatives, I would favor the latter. Debt-to-equity ratios quickly get into complicated questions of the accounting treatment of tangible and intangible assets and many others. Dealing with interest rates alone would be far simpler.

Whether the impact of either of these approaches would be sufficiently beneficial to outweigh the considerable problems created by their implementation is questionable. A number of sophisticated models would have to test their validity before one could reach any conclusion with confidence.

Such limitations, however, if they were to be considered, should not be put into effect without two additional changes in the Tax Code.

First, the double tax on dividends should be eliminated and the payment of dividends on common stock be made deductible.

Second, the capital gains tax schedule should be changed so as to provide a lower rate for long-term holdings and a higher rate for short-swing profits.

I assume that there would be a net revenue loss from such a package, despite the revenue raising nature of the nondeductibility of some interest and the higher tax on short-swing profits. Some aspects of such a proposal would therefore have to be phased in over time in order to take into account the realities of our overall budget deficit.

Four, junk bonds were, at their inception, and still are a perfectly acceptable way to finance growing businesses which have not yet developed acceptance in the marketplace. In moderate amounts, they have their place among the myriad financial instruments which the combination of computer technology and innovative bankers have created over the last decade.

Used in huge amounts, as parts of takeovers, LBO's or restructurings, they create an entirely different dynamic.

In good economic times, such as we have had over the last 7 years, junk bonds provide returns so much greater than competing investments that they have become irresistible to financial institutions which are required to show short-term performance, for example, mutual funds trying to attract investors; pension fund managers eager to show performance; S&L or insurance company managers in need for high returns.

The extremely high yields on these bonds represent, essentially, an enormous transfer of wealth from production to capital. As a result, since capital is being overcompensated, a very large institutional market, presently on the order of $200 billion or more, was developed.

They also became the favorite financing vehicle for takeovers and LBO's, and subsequently, leveraged restructurings. The same characteristics, however, which made them attractive to certain types of institutions, have some important additional implications.

First, the overcompensation of capital requires relatively rapid asset sales to maintain viable operations for the rest of the business. Hence, the "bust-up" nature of many to these takeovers.

Second, the interest charges in an economic downturn might not be tolerable. We have yet to experience such a downturn in the current business cycle, but we have already seen more evidence of potential difficulty with some overly aggressively financed takeovers or LBO's.

The latest developments in these securities have been more aggressive still with provisions for interest (or dividends in the case of preferred stocks) to be made in additional bonds or stock, as the case may be. Wherever one turns, the financial pyramids get higher and higher.

Junk bonds, and their derivatives, are a product of a unique convergence of circumstances in the decade of the 1980's: deregulation; computer technology; very aggressive institutions (many of them government-insured); huge amounts of liquidity; falling interest rates and booming markets for assets.

The success of highly leveraged takeovers and of LBO's is due to this combination of circumstances but, more than any other factor, to the willingness of financial institutions to invest in junk bonds in the hundreds of billions of dollars and of the banks to be more and more aggressive in providing credit.

Without the aggressive policies of financial institutions, the leveraging of American business could not have happened on nearly this scale.

In addition to the institutional market for junk bonds, a new vehicle has been developed by the investment banking community: It is called the bridge loan. The bridge loan, as the name implies, is a supposedly short-term credit provided by an investment banking house to a client engaged in a takeover or an LBO, to be refinanced by junk bonds in the public market several months later.

In some cases, the bridge loans have exceeded the total net capital of the firms extending the loans. If, someday, there is a real problem in the junk bond market, and the refinancing of some of these bridge loans becomes problematical, we will have an additional and potentially serious credit problem in the securities industry.

Five, regulation is an area that can be used more aggressively in protecting the U.S. economy from excessive leverage. Federal Reserve Board Chairman, Alan Greenspan, has expressed concern at heavy bank participation in takeovers and LBO's.

At the same time, it must be remembered that during the October 1987 stock market crash, the Fed essentially guaranteed the securities industry by, quite correctly, advising the banks to provide whatever liquidity was necessary to the securities houses. It does mean, however, that the Fed has an interest in the adequacy of capital of the securities industry as well as of the commercial banks.

The Fed can certainly raise reserve requirements for certain types of bank credits based on risk evaluation. The SEC and the Stock Exchanges can, and should, require that bridge loans provided by securities houses, and similar instruments, be financed by permanent capital to a much greater extent.

These actions should also be coordinated with foreign banking and security regulators.

The scandal of the S&L industry, which will ultimately cost American taxpayers $100 billion or more, is a clear example of the failure of deregulation.

Among other things, it will require a thorough review of Federal Deposit Insurance, not only among S&L's, but throughout the banking system. While such a review takes place, a 5-year moratorium should be placed on the ability of any institutions carrying Federal Deposit Insurance—bank or S&L—from acquiring below-investment grade securities of any type.

At the same time, a review of ERISA should be made with respect to similar questions. Strict limits should be set—both in relative amounts and in concentration—on pension fund participation in the junk bond market and higher standards of care and diligence should apply to fund managers making such investments.

With respect to management-involved LBO's, the main issues to be dealt with are the result of the real conflict between management as a potential buyer on the one hand, and management's obligation to the board and the shareholders on the other.

Full disclosure of management's plans, and possibly, a longer time frame than normal tender offers—say, 60 to 90 days—in order to provide for clear opportunities to find competing bids, all of these should be reviewed.

A last, but important question to be reviewed from a regulatory point of view, is the amount of firm financing required to launch a tender offer. At the present time, tender offers are launched with actual commitments of as little as 15-20 percent of the total amount required together with "highly confident" letters for the balance from a variety of financial institutions.

It is worth considering whether higher minimum firm commitments should be required before allowing a tender offer to be made. It is obvious that such a requirement would favor the large bidder over the small one; on the other hand, though, the large bidder is usually more strongly financed and the resulting capital structures are likely to be sounder.

Finally, the role and the responsibilities of financial institutions in the takeover and LBO field are all pervasive. As acquirers of junk bonds; participants in LBO pools; in many cases, as the largest shareholders of corporations being taken over or restructured; their impact is far reaching.

The term "financial institution," however, is a very broad one. It includes mutual funds; public and private pensions funds; S&L's; banks, domestic and foreign; hedge funds; and many others.

In general, however, it can be said that the outlook of all of these holders is for near-term profits rather than long-term views. The result is constant pressure on management to maximize immediate stock-market returns by restructuring, sale of the company and/or large scale stock repurchases.

Together with arbitragers, the financial institutions have become more and more a destabilizing influence in corporate America, as opposed to the greater stability provided by Japanese and European institutional shareholders.

The fault, however, does not lie solely with the money managers. True, their compensation is too often geared to short-term performance.

But the earnings pressure of corporations whose pension funds they manage is also a factor as well as the competitive standards set by the trustees of public pension funds. We are talking of an entire culture there, not of a few culprits.

What can one conclude from these various questions? LBO's, takeovers, restructurings, junk bonds, et cetera, all of these are not causes but effects. They are the effects of imbalances created in the economy by the various relationships that I have described and by a generally highly speculative environment fostered in the 1980's.

It is clear that something is structurally wrong here insofar as economic rewards and incentives are concerned, in the relationship between corporations and their various constituencies, and in the performance of financial institutions and their regulators.

The fact that, at present, State and Federal courts play a more important role in corporate governance than corporate boards of directors, their managements or their advisers, is another indication that change is required.

The Congress and the administration, if they so choose, can obviously deal with some of these issues piecemeal, by amending some tax laws and changing some regulations. However, the issue goes to the basic functioning of the financial markets and to the ability of the United States to make adequate new investments in our economy.

It may be time for an equivalent of the Cohen commission of the 1960's to provide an objective review of the markets and these matters to the Congress and the administration, together with a set of recommendations, both legislative and regulatory, that could change the direction we are presently embarked on.

Such a commission should include leaders from the business and the financial community as well as from the administration and the Congress. It should operate under a 2-year timetable recognizing that failure to agree on constructive recommendations for structural change is likely to result in much more drastic legislative action by the Congress.

In the last analysis, this country needs to shift from consumption to investment. Major world powers have, historically, been characterized by hard money and low interest rates instead of the other way around; they have been exporters of capital and technology instead of borrowers.

This should be our national objective and it will require very basic changes in our national policies, starting with real reductions in our budget and trade deficit. The shift from debt to equity investment suggested in my testimony is just one aspect of such a national investment strategy.

My firm has been involved, as an advisor, in some of the largest takeovers and LBO's which have taken place in the last decade. We will continue so to be involved. Our clients require advice on these matters and it is our business to provide it, within the framework of existing laws and regulations, as prudently and responsibly as we know how.

I am perfectly aware of the fact that the questions I have raised in my testimony could result in a curtailment of this activity, for my firm and for the financial industry as a whole. It could affect the financial markets negatively for some period of time.

Ultimately, however, if it results in a healthier economy, it will benefit the markets as well as our clients and our business.

Thank you.

[The statement of Mr. Rohatyn follows:]

Testimony by

FELIX G. ROHATYN

General Partner, Lazard Freres & Co.

I am pleased to be here today because I believe it is of great importance that the Congress fully understand some of the issues which trouble our economy and signal this concern to leaders in the Government and private sector. I do not believe that Congress can, or should, necessarily assume responsibility to solve these problems solely by legislation. On the contrary, it is a combination of enlightened partnership between Congress, the Administration and the leaders of American business and finance which can best deal with these issues and formulate public policy which serve the interests of the Nation. Of course, in this context, I believe there are specific actions the Congress can take and I will today address myself to them.

There is a growing lack of confidence in the U.S. in the integrity of the financial system and in the ability of our economy to maintain itself in an increasingly complex and competitive world. This lack of confidence is more and more focused, especially since October 19, 1987, on the activities of the financial community which is viewed, by many sectors of American Society, as a parasite instead of a contributing force to the growth of this Country.

The recent spate of large LBO's has focused concerns in the Congress. This has occurred against a backdrop of of higher and higher losses and taxpayer financed bailouts in the S&L industry; the legal problems of certain members of the financial community; and renewed questions about the soundness of the U.S. banking system not only because of LBO's but because of renewed Third World Debt problems as well as other sizeable credit risks. I strongly support Treasury Secretary Brady's thoughtful testimony on this issue.

The reasons for this sudden renewed interest on the part of the Congress, after a brief spurt of activity following the Boesky scandal, are a mix of economic policy concerns as well as a reflection of the highly negative public reaction generated by some of these transactions. None of this is very new. The whole panoply of issues presently discussed has been argued about for the past several years: Junk bonds; hostile versus friendly takeovers; LBO's and the impact of high leverage; the role of institutional investors; the ethics of the financial community. What is new is the mammoth size of recent transactions (topped off by RJR Nabisco); the financial profits generated as a result; and new questions raised about the rights of bondholders in such transactions; the oldest issue of all, namely the fiduciary obligations of management to stockholders, bondholders, employees, communities, etc.; the relationships between institutions such as pension funds and the investment vehicles which carry out takeovers and LBO's, whether friendly or not; and many others.

These are issues that are very complicated at best and not easily subject to exact quantitative analysis. In addition, they involve very large economic interests. But what is really involved here is what shape American business is in - and will be in - approaching the 21st century, and our level of confidence in the quality, skills and judgement of the business and financial institutions which are the backbone of our economy.

These are some, but by no means, all of the issues involved here. There will probably be as many views on these issues as there will be participants in the debate. For whatever they are worth, I will set forth certain of my own views:

The argument that high levels of debt, combined with significant management ownership, hones the enterpreneurial spirit of the management and focuses their energies is questionable. Management ownership is highly desirable; so is employee ownership, profit-sharing, etc. But managements can be highly motivated without mountains of debt to make them more efficient. One should also remember that the companies with the best records of operating performance, as well as the best records of employee relationship, innovation and community relationships, are those with strong balance sheets, high levels of investment and high levels of R & D. They are theIBM's and the DEC's; the Pfizers and the Mercks; the Coca-Colas and the General Electrics. Their use of leverage has increased in the last decade because economic incentives do require it; but, they have kept their levels of debt to reasonable amounts and have had no recourse to the more exotic instruments created by the junk bond market.

Over the last five years, more than $400 billion in equities of U.S. companies have been retired and replaced with debt. This is a distinctly American phenomenom. In most Western countries, companies are not permitted to, or severely constrained from buying in their own stock. The stripping away of equity to be replaced by debt simply cannot take place on such a scale.

This is quite different from the current use of credit in the U.S. which is, more often than not, geared to disinvestment rather than investment and which forces companies more and more to operate in a liquidation mode rather than in a forward-looking, aggressive new investment mode.

There are several interrelated issues which the Committee must consider, since they all relate to one another. They are: Leverage; takeovers, taxes; junk bonds; regulation; and financial institutions. I will briefly discuss each:

1) Leverage. The judicious, even aggressive use of credit is a perfectly normal and acceptable business strategy. The issues that are troublesome at this time, and that differentiate the recent use of leverage from other times are:

a) The dramatic debt to equity ratios built up in many takeovers, restructurings and LBO's. Ratios of 90-10 debt to equity, or higher, are not uncommon. In addition, what counts as equity often consists of subordinated debt or preferred stock, with interest or dividends payable in additional paper, that further reduce the amount of real capital invested.

b) The use of significant amounts of junk bonds as part of these structures. These bonds carry interest rates ranging from 13 to 18%, often more than the average return on investment of the underlying business. Together with excessively heavy debt to equity ratio, the businesses are burdened with interest costs that are excessive in amounts and probably not sustainable through a full business cycle.

c) The fact that much of the debt is paid out to reacquire the company's own stock, or another company's stock, at a significant premium, instead of being invested in the company's own business for internal growth limits potential for future investment and growth.

2) Takeovers. It is unwise to attribute economically beneficial or harmful qualities to takeovers. Study after study has failed to show any hard and fast conclusion. This is also true of their moral values. Takeovers are neither good nor bad, whether they are friendly or hostile. That is also true of LBO's.

Takeovers and LBO's do have implications to our national economy, but those implications depend on the validity of the business strategy, on the soundness of their financial structure, and on the fairness to the shareholder of both the acquiring and acquired company.

The soundness of financial structures has clear implications for new investment and economic activity. It requires, in general, greater use of equity instead of debt. The taxing, as well as the regulatory system, could be used for that purpose. The fairness to shareholders, and of the takeover process, is a basic requirement to maintain healthy capital markets and individual participation. These are important national assets.

Fairness to shareholders may require differentiating management-led LBO's from other transactions. This can be done by regulatory changes or, possibly, legal changes.

Finally, massive repurchases of equities with borrowed funds should be discouraged. Many countries do not permit reacquisition of a company's own stock as a matter of law; we do not need to go so far. The acquisition of stock required for stock options or stock purchase plans is a perfectly normal transaction; the equity will be reissued when the options are exercised. The acquisition of stock with the proceeds of the sale of certain assets is similarly neutral from a capital point of view. But massive repurchases as part of leveraged restructurings are essentially not different from LBO's; the public provides the equity with the retention of a "stub", in lieu of the LBO house. The economics, and the related problems, are the same.

3) Taxes. The taxing system can be used to redress the present tendency to overleverage the economy, and to encourage long-term investment instead of short-swing speculation. Any time the taxing system is involved, questions of fairness, of practicality and of unexpected repercussions have to be taken into account. The argument has been made that eliminating some or all of the deductibility of interest in highly leveraged takeover or LBO situations would help foreign companies which are not subject to such penalties. That is not necessarily the case. Foreign companies rarely have 90-10 debt/equity ratios nor do they pay 14-16% interest rates for their financing. Furthermore, in many cases, foreign companies finance their acquisitions in the U.S. and are subject to the same tax treatment. If we wish to put U.S. companies on a more even footing with their foreign competitors when it comes to acquisitions (and we should) it would be more important to change the accounting rules governing the writeoff of goodwill; that could truly be helpful.

As to taxes, leverage can be discouraged in two ways. The old "thin incorporation doctrine" suggested that debt in excess of a certain percentage of total capital was in reality equity, and that the interest thereon was a dividend, therefore non-deductible.

Another possibility would be to suggest that junk bonds, because of their excessively high interest rates, consist in reality of an interest rate plus a liquidating return on capital. The allowable deductible interest could be set at some relationships to the yield of an investment-related bond of equivalent maturity. Either of these limitations could only apply to companies that had made substantial acquisitions (or reacquired substantial amounts of their own stock) within a specified period. Such regulations would be rather cumbersome to implement, but not impossible.

Of the two alternatives, I would favor the latter. Debt to equity ratios quickly get into complicated questions of the accounting treatment of tangible and intangible assets and many others. Dealing with interest rates alone would be far simpler. Whether the impact of either of these approaches would be sufficiently beneficial to outweigh the considerable problems created by their implementation is questionable. A number of sophisticated economic models would have to test their validity before one could reach any conclusion with confidence.

Such limitations, however, if they were to be considered, should not be put into effect without two additional changes in the tax code. First, the double tax on dividends should be eliminated and the payment of dividends on common stock be made deductible. Second, the capital gains tax schedule should be changed so as to provide a lower rate for long-term holdings and a higher rate for short-swing profits.

I assume that there would be a net revenue loss from such a package, despite the revenue raising nature of the non-deductibility of some interest and the higher tax on short-swing profits. Some aspects of such a proposal would therefore have to be phased in over time in order to take into account the realities of our overall budget deficit.

4) Junk bonds were, at their inception, and still are a perfectly acceptable way to finance growing businesses which have not yet developed acceptance in the market

place. In moderate amounts, they have their place among the myriad financial instruments which the combination of computer technology and innovative bankers have created over the last decade. Used in huge amounts, as parts of takeovers, LBO's or restructurings, they create an entirely different dynamic.

In good economic times, such as we have had over the last seven years, junk bonds provide returns so much greater than competing investments that they have become irresistible to financial institutions which are required to show short-termperformance, i.e. mutual funds trying to attract investors; pension fund managers eager to show performance; S&L or insurance company managers in need for high returns. The extremely high-yields on these bonds represent, essentially, an enormous transfer of wealth from production to capital. As a result, since capital is being overcompensated, a very large institutional market, presently on the order of $200 billion or more was developed. They also became the favorite financing vehicle for takeovers and LBO's, and subsequently, leveraged restructurings. The same characteristics, however, which made them attractive to certain types of institutions, have some important additional implications. First, the overcompensation of capital requires relatively rapid asset sales to maintain viable operations for the rest of the business. Hence, the "bust-up" nature of many to these takeovers. Second, the interest charges in an economic downturn might not be tolerable. We have yet to experience such a downturn in the current business cycle, but we have already seen some evidence of potential difficulty with some overly aggressively financed takeovers or LBO's.

The latest developments in these securities have been more aggressive still with provisions for interest (or dividends in the case of preferred stocks) to be made in additional bonds or stock, as the case may be. Wherever one turns, the financial pyramids get higher and higher.

Junk bonds, and their derivatives, are a product of a unique convergence of circumstances in the decade of the 1980s: deregulation; computer technology; very aggressive institutions (many of them government-insured); huge amounts of liquidity; falling interest rates and booming markets for assets. The success of highly leveraged takeovers and of LBO's is due to this combination of circumstances but, more than any other factor, to the willingness of financial institutions to invest in junk bonds in the hundreds of billions of dollars and of the banks to be more and more aggressive in providing credit. Without the aggressive policies of financial institutions, the leveraging of American business could not have happened on nearly this scale.

In addition to the institutional market for junk bonds, a new vehicle has been developed by the investment banking community: It is called the bridge loan. The bridge loan, as the name implies, is a supposedly short-term credit provided by an investment banking house to a client engaged in a takeover or an LBO. The so-called bridge is then to be refinanced by junk bonds in the public market several months later. It is an innovative instrument, created to compete with the "highly confident" letters first provided by Drexel Burnham as assurances of financing. However, in some cases, the bridge loans have exceeded the total net capital of the firms extending the loans; the investment houses finance themselves by the sale of very short-term commercial paper. If, someday, there is a real problem in the junkbond market, and the refinancing of some of these bridge loans becomes problematical, we will have an additional and potentially serious credit problem in the securities industry.

5) Regulation. This is an area that can be used more aggressively in protecting the U.S. economy from excessive leverage. Federal Reserve Board Chairman, Alan Greenspan, has expressed concern at heavy bank participation in takeovers and LBO's. At the same time, it must be remembered that during the October 1987 stock market crash, the FED essentially guaranteed the securities industry by, quite correctly, advising the banks to provide whatever liquidity was necessary to the securities houses. It does mean, however, that the Fed has an interest in the adequacy of capital of the securities industry as well as of the commercial banks.

The Fed can certainly raise reserve requirements for certain types of bank credits based on risk evaluation. The SEC and the Stock Exchanges can, and should, require that bridge loans provided by securities houses, and similar instruments, be financed by permanent capital to a much greater extent. These actions should also be coordinated with foreign banking and security regulators.

The scandal of the S&L industry, which will ultimately cost American taxpayers $100 billion or more, is a clear example of the failure of deregulation. Among other things, it will require a thorough review of Federal Deposit Insurance, not only among S&L's, but throughout the banking system. While such a review takes place, a 5-year moratorium should be placed on the ability of any institutions carrying Federal Deposit Insurance (bank or

S&L) from acquiring below-investment grade securities of any type.

At the same time, a review of ERISA should be made with respect to similar questions. Strict limits should be set (both in relative amounts and in concentration) on pension fund participation in the junk bond market and higher standards of care and diligence should apply to fund managers making such investments.

With respect to management-involved LBO's, the main issues to be dealt with are the result of the real conflict between management as a potential buyer on the one hand, and management's obligation to the Board and the shareholders on the other. Full disclosure of management's plans, and possibly, a longer time frame than normal tender offers (say 60-90 days) in order to provide for clear opportunities to find competing bids, all of these should be reviewed.

A last, but important question to be reviewed from a regulatory point of view, is the amount of firm financing required to launch a tender offer. At the present time, tender offers are launched with actual commitments of as little as 15-20% of the total amount required together with "highly confident" letters for the balance from a variety of financial institutions. The high cost of getting firm commitments, witout assurance of success, is obviously the main deterrent to higher levels of financing being obtained. It is worth considering whether greater minimum firm commitment should be required before allowing a tender offer to be made. It is obvious that such a requirement would favor the large bidder over the small one; on the other hand, though, the large bidder is usually more strongly financed and the resulting capital structures are likely to be sounder.

6) Financial Institutions. The role and the responsibilities of financial institutions in the takeover and LBO field are all pervasive. As acquirers of junk bonds; participants in LBO pools; in many cases as the largest shareholders of corporations being taken over or restructured; their impact is far reaching. The term "financial institution", however, is a very broad one. It includes mutual funds; public and private pensions funds; S&L's; banks, domestic and foreign; hedge funds; and many others. In general, however, it can be said that the outlook of all of these holders is for near-term profits rather than long-term views. The result is constant pressure on management to maximize immediate stock-market returns by restructuring (which can result in higher

efficiency, but which can also reduce long-term competitivenes); sale of the company and/or large scale stock repurchases. Together with arbitrageurs, the financial institutions have become more and more a destabilizing influence in corporate America, as opposed to the greater stability provided by Japanese and European institutional shareholders.

The fault, however, does not lie solely with the money managers. True, their compensation is too often geared to short-term performance. But the earnings pressure of corporations whose pensions funds they manage is also a factor as well as the competitive standards set by the trustees of public pension funds. We are talking of an entire culture here, not of a few culprits.

What can one conclude from these various questions? LBO's, takeovers, restructurings, junk bonds, etc., all of these are not causes but effects. They are the effects of unbalances created in the economy by the various relationships that I have described and by a generally highly speculative environment fostered in the 1980s. It is clear that something is structurally wrong here insofar as economic rewards and incentives are concerned, in the relationship between corporations and their various constituencies, and in the performance of financial institutions and their regulators. The fact that, at present, state and federal courts play a more important role in corporate governance than corporate Boards of Directors, their managements or their advisers, is another indication that change is required.

The Congress and the Administration, if they so choose, can obviously deal with some of these issues piecemeal, by amending some tax laws and changing some regulations. However, the issue goes to the basic functioning of the financial markets and to the ability of the U.S. to make adequate new investments in our economy. It may be time for an equivalent of the Cohen Commission of the 1960s to provide an objective review of these matters to the Congress and the Administration, together with a set of recommendations, both legislative and regulatory, that could change the direction we are presently embarked on. Such a Commission should include leaders from the business and the financial Community as well as from the Administration and the Congress. It should operate under a two-year timetable recognizing that failure to agree on constructive recommendations for structural change is likely to result in much more drastic legislative action by the Congress.

In the last analysis, this Country needs to shift from consumption to investment. Major world powers have, historically, been characterized by hard money and low interest rates instead of the other way around; they have been exporters of capital and technology instead of borrowers. This should be our national objective and it will require very basic changes in our national policies, starting with real reductions in our budget and trade deficit. The shift from debt to equity investment suggested in my testimony is just one aspect of such a national investment strategy.

My firm has been involved, as an advisor, in some of the largest takeovers and LBO's which have taken place in the last decade. We will continue so to be involved. Our clients require advice on these matters and it is our business to provide it, within the framework of existing laws and regulations, as prudently and responsibly as we know how. I am perfectly aware of the fact that the questions I have raised in my testimony could result in a curtailment of this activity, for my firm and for the financial industry as a whole. It could affect the financial markets negatively for some period of time. Ultimately, however, if it results in a healthier economy, it will benefit the markets as well as our clients and our business.

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Chairman Rostenkowski. Mr. Feldstein.

STATEMENT OF MARTIN FELDSTEIN, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MA, AND PRESIDENT, THE NATIONAL BUREAU OF ECONOMIC RESEARCH (FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS)

Mr. Feldstein. Thank you very much, Mr. Chairman. As always, I'm pleased to be back with the members of this committee and to participate in this marathon day-long hearing.

It is easy enough to understand how excessive levels of corporate debt could lead to financial instability and could turn an ordinary recession into a much more severe downturn. But I am not going to dwell on these systemic risks that could result from too much debt. I want to make two brief points on that subject because I think that the possibility of excess debt may be exaggerated.

First, corporate debt in the United States is far lower as a percentage of GNP than in other industrial countries.

Second, corporate borrowers are generally being very careful to structure their debt in such a way that if a corporation finds that it cannot meet its full interest obligations, the subordinated debt holder has incentives to cooperate with management in sustaining business activity rather than in causing a dissolution of the corporation. I don't think that we have created a situation of financial disaster in our current corporate leverage. Nevertheless, I believe that there can be no doubt that our tax rules have pushed corporations to greater reliance on debt than they would otherwise choose and then would otherwise be desirable from the standpoint of their shareholders.

Companies and shareholders are taking greater risks than they should because of the strong incentives provided by our tax system.

I want to focus my remarks today on the tax bias toward debt inherent in the current tax system and the increased incentives to use debt that have been created by the tax legislation of the 1980's. In the end I want to suggest a change in tax rules that could eliminate this distortion and indeed could also strengthen overall business investment.

Until a few years ago corporations were rather reluctant to accept high levels of debt despite the fact that interest payments on corporate debt are deductible. Although the restrained level of debt depressed the return to equity investors, and therefore lowered the price of corporates shares, it is easy to understand why corporate managers were nevertheless reluctant to use as much debt as their shareholders might want. Although a shareholder can accept the risk of an occasional bankruptcy if the average return on his portfolios of stock, a bankruptcy could destroy the career as well as the personal fortune of a corporate manager. In recent years, however, managers have overcome their previous reluctance and have begun to increase their debt-equity ratio. One reason for the change in their behavior has been the fear of a hostile takeover if they do not increase the return to shareholders through greater leverage.

The 1980's have also seen three important changes in tax rules that increase the relative attractiveness of debt, and that by doing so have added impetus to hostile takeovers as well. I suspect this committee in designing and voting for those tax changes did not intend that impact on corporate debt.

First is the new corporate and personal tax rates. The new corporate and personal tax rates makes the rate at which corporate interest payments are deductible higher than the rate at which individuals can deduct personal interest payments. It makes tax sense for corporations to borrow more and for individuals to hold more debt in their personal portfolios. Just what we have been seeing.

Second are the limitations on the deduction of investment interest expense. Because of these new limitations on the ability of individuals to deduct investment interest expenses, an investor who prefers a high debt-equity ratio may want the corporations in which he invests to do additional borrowing to replace the personal borrowing that he can no longer do in a tax deductible way.

Third, the sharp rise in the tax rate on capital gains relative to the rate on interest income induces households to prefer more debt and less equity, further encouraging corporations to increase their debt equity ratio.

Tax incentives of the sort that I have been describing effect not only debt in general but mergers and acquisitions in particular. The increase in mergers and acquisitions is in part a response to a strong tax incentive, although that may not be so clear even to those who are involved. Nevertheless, market pressures and the fear of hostile takeovers induces corporate managers to engage in LBO's that are tax wise but that would not otherwise be justified.

The key here is that dividends are a very expensive way for corporations to get profits into the pockets of shareholders since every dollar of dividends is fully taxed at the recipient's marginal tax rate. A repurchase is more tax efficient because the individual who sells his stock pays a capital gains tax on only the difference between the selling price of the stock and the investor's original cost. Even with equal tax rates on capital gains and dividends, share repurchases are the more tax efficient than are dividends.

Seen in this light, an acquisition of one corporation by another has tax advantages similar to a share repurchase. The acquired company distributes some of its retained earnings which gets into the pockets of individuals subject only to the capital gains tax on the difference between the purchase price and the cost of the shares. Although the acquirer has not put additional cash into the pockets of their own shareholders, to the corporate sector as a whole, there has been a clear payout of earnings that would otherwise remain trapped in the corporation.

The debt financed acquisition is even more attractive to corporate management and shareholders because it combines the tax benefits of an equity financed acquisition with the extra tax advantage of increased debt. The debt financed acquisition is equivalent to an acquisition financed by equity plus borrowing by the acquiring company to replace the lost equity with debt.

There is no doubt in my mind that existing tax rules provide a strong incentive to increase corporate debt. Although this implies greater financial risk than would otherwise occur, it does have the offsetting advantage of lowering the overall tax burden on corporate capital which in turn reduces the bias against corporate investments and increases the overall incentive to save and invest. Nevertheless, these offsetting advantages are simply not enough to justify the existing distortions. It is possible to modify current tax rules in a way that would neither increase nor decrease the overall tax burden on corporate capital, but that would reduce the current bias in favor of debt. Before I look briefly at one such possible change in tax rules, I want to comment on a second, very serious distortion that remains in the tax law and that can be eliminated by the same change in tax rules.

As you all know, one of the most important ideas that shaped the 1986 act was the concept of a level playing field that provides equally effective tax treatment to different types of business investments. The idea is a good one that should in principle increase the overall productivity of total investment. Unfortunately, although the 1986 tax law may have reduced the tax differential between equipment and structures, it did so in a way that increased the tax bias against all investment in business plant and equipment relative to other kinds of business and nonbusiness outlays.

The analysis that supported the elimination of the investment tax credit and the reduction of deprecation allowance as a means of achieving a more even playing field was incorrect because it ignored the wide range of investments that corporations make in addition to their outlays for equipment and structures. A corporation, after all, is investing whenever it gives up current profits in the hope of increasing future profits. Spending money for new plant and equipment is just one way of doing that. A firm is also investing when it spends money on advertising or on improvements in customer relations or on recruiting employees or on research and investment. A firm also invests when it reduces current prices to increase its market share and thereby raise future profits.

There is a key difference between investment in plants and equipment and the intangible investments in advertising, customer good will, market share and personnel. The outlays on equipment and structures are not immediately deducted in calculating taxable income but are spread over a number of years. In contrast, all of the other forms of investment are deducted immediately in calculating taxable income. The current tax law, therefore, imparts a significant bias in favor of doing intangible investments. This bias was increased by the 1986 tax changes that increased the effective tax rates on equipment and structures. This bias in favor of intangible investments lowers overall productivity because it diverts scarce corporate funds away from plant and equipment and new less productive forms of investment. Moreover, although investments in advertising and market share may eventually raise the earnings of the investing corporation, that extra profit comes largely at the expenses of other companies. National output and productivity are simply not increased.

In short, we have a tax system that distorts both the way the corporations finance themselves and the investments that they make. Too little equity and too much debt, coupled with too little investment in plant and equipment and too much investment in advertising, customer relations and the investment of market share. There is a tax reform that would simultaneously eliminate both of these distortions. The tax flow business tax. It would change our current corporate tax rules in two important ways. First, interest payments would no longer be deductible. Second, all investments in plant and equipment and in inventories would be immediately deductible. This kind of tax is called a cash flow tax because it is levied on the company's cash revenue minus all cash expenses, including investment but excluding the company's payments to the providers of its equity and its debt capital. Eliminating the deduction for interest would put debt and equity on an equal footing and would eliminate the current tax bias to use excessive debt. The immediate expensing of all investments in structures, equipment and inventories would put such investments on a level playing field with advertising, personnel training and other intangible investments for which current tax law already permit expensing.

The cash flow business tax would eliminate the two most important distortions caused by our current business tax rules. Also eliminated would be the complex regulations defining the difference between debt and equity and spelling out the depreciation provisions for different types of assets. What about the revenue effect of such a change? I've not done a detailed calculation, but some rough estimates indicate the revenue gain from disallowing interest would just about pay for the revenue cost of immediate expensing of all investments. The overall change in tax rules could therefore be kept revenue neutral by at most a small change in the corporate tax rate. There would of course, be transition problems and special issues in dealing with financing corporations. But the shift to a cash flow business tax would produce a simpler, fairer and more efficient tax system.

This committee might quite reasonably decide after these hearings that the increase in corporate debt does not present a substantial danger to the stability of our economy and therefore that, despite the serious distortions to our business finance and investment caused by existing tax rules, America has had enough tax reform for one decade. But if you do decide that the tax bias in favor of the debt and against investment in plant and equipment should be eliminated, I recommend that you consider the cash flow business tax.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Excess Debt and Unbalanced Investment: The Case for a Cashflow Business Tax

Statement of
Martin Feldstein

Professor of Economics, Harvard University
President, The National Bureau of Economic Research

before the

Committee on Ways and Means
United States Congress

January 31, 1989

Thank you, Mr. Chairman. I am very pleased to participate in this opening day of hearings on the relation of the tax law to the rise in corporate debt.

Corporate Debt and Financial Disaster

It is easy to understand how excessive levels of corporate debt could lead to financial instability and could turn an ordinary recession into a much more severe downturn. When corporate debt levels are excessive, a sharp rise in interest rates or a sharp decline in operating income could trigger a series of cascading defaults that could undermine both industrial firms and financial institutions.

I shall not dwell on the systemic risks that could result from high levels of corporate debt. I am here today with three distinguished witnesses -- Benjamin Friedman, Henry Kaufman and Felix Rohatyn -- who have warned repeatedly about the danger of the current level of corporate debt. A quartet of Cassandras is at least one too many. I shall therefore leave it to them to elaborate on the risks associated with current and prospective debt levels.

Moreover, although I appreciate the possibility that excess debt can cause financial instability, I am impressed by two considerations that suggest that the risks inherent in current corporate debt levels may be exaggerated. First, corporate debt in the United States is far lower as a percentage of GNP than in other industrial countries. Second, corporate borrowers are generally being very careful to structure their debt in such a way that, if the corporation cannot meet its full interest obligations, the subordinated debt holders would have strong incentives to cooperate with management in sustaining business activity rather than in causing a dissolution of the corporation.

But even if we are not near the brink of financial disaster, I believe that there can be no doubt that our tax rules have pushed corporations to greater reliance on debt than they would otherwise choose and than would otherwise be desirable from the standpoint of their shareholders. Companies and shareholders are taking greater risks than they should because of the strong incentives provided by our tax system.

I want to focus my remarks today on the tax bias toward debt finance inherent in the current tax system and the increased incentives to use debt that have been created by the tax legislation of the 1980s. I will also suggest a change in tax rules that could eliminate this distortion and strengthen overall business investment.

The Tax Bias Toward Excessive Debt

Until a few years ago, corporations were generally reluctant to accept high levels of debt despite the fact that interest payments on corporate debt are tax deductible while dividend payments are not deductible. Although the restrained level of debt depressed the return to equity investors and therefore the price of corporate shares, it is easy to understand why corporate managers were nevertheless reluctant to use as much debt as their shareholders might want. While the shareholder who owns the stocks of many companies can accept the risk of an occasional bankruptcy if the average return on his portfolio of stocks is high enough, a bankruptcy could destroy the careers as well as the personal fortunes of corporate managers.

In recent years, however, managers have overcome their previous reluctance and have begun to increase their debt-equity ratios. One reason for the change in their behavior has been the fear of a hostile takeover if they did not increase the return to shareholders through greater leverage. But the 1980s have also seen three important changes in tax rules that increase the relative attractiveness of debt and that, by doing so, have added impetus to hostile takeovers as well:

(1) The new corporate and personal tax rates make the rate at which corporate interest payments are deducted substantially higher than the rate at which individuals can deduct personal interest payments. It therefore makes tax sense for corporations to borrow more and for individuals to hold more debt in their personal portfolios, just what we have been seeing.

(2) Because of the new limitations on the ability of individuals to deduct investment interest expenses, an investor who prefers a high debt-equity ratio may want the corporations in which he invests to do additional borrowing to replace the personal borrowing that he can no longer do in a tax-deductible way.

(3) The sharp rise in the tax rate on capital gains relative to the rate on interest income induces households to prefer more debt and less equity, further encouraging corporations to increase their debt-equity ratios.

The Tax Incentive to Mergers, Acquisitions, and LBOs

The increase in mergers and acquisitions is also in part a response to a strong tax incentive, although one that may not be so clear even to those who are involved. Nevertheless, market pressures and the fear of hostile takeovers induce corporate managers to engage in M and A activity and in LBOs that are tax-wise but that would not otherwise be justified.

The key here is that dividends are a very expensive way for corporations to get profits into the pockets of shareholders since every dollar of dividends in fully taxed at the recipient's marginal tax rate. In contrast, a share repurchase is more "tax efficient" because the individual who sells his stock pays a capital gains tax only on the difference between the selling price of the stock and the investor's original cost. Even with equal tax rates on capital gains and dividends, share repurchases are thus more tax efficient than dividends.

Seen in this light, an acquisition of one corporation by another has tax advantages similar to a share repurchase. The acquiring company distributes some of its retained earnings which get into the pockets of individuals subject only to the capital gains tax on the increase in the value of their shares. Although the acquirer has not put additional cash into the pocket of its own shareholders, for the corporate sector as a whole there has been a clear payout of earnings that would otherwise remain trapped in the corporation.

The debt financed acquisition or leveraged buyout is even more attractive to corporate managements and shareholders because it combines the tax benefits of an equity financed acquisition with the extra tax advantage of increased debt. The debt financed acquisition is equivalent to an acquisition financed by equity plus borrowing by the acquiring company to replace the lost equity with debt.

There is no doubt in my mind that existing tax rules provide a strong incentive to increase corporate debt. Although this implies greater financial risk than would otherwise occur, it does have the offsetting advantage of lowering the overall tax burden on corporate capital. This in turn reduces the bias against corporate investments and increases the overall incentive to save and invest.

Nevertheless, these offsetting advantages are not enough to justify the existing distortions. It is possible to modify current tax rules in a way that would neither increase nor decrease the overall tax burden on corporate capital but that would reduce the current bias in favor of debt.

The Tax Bias Against Plant and Equipment Investments

Before looking briefly at one such possible change in tax rules, I want to comment on a second very serious distortion that remains in the tax law and that can be eliminated by the same change in tax rules.

One of the important ideas that shaped the 1986 tax legislation was the concept of a "level playing field" that provides equal effective tax treatment to different types of business investments. The idea is a good one that should in principle increase the overall productivity of total investment.

Unfortunately, however, although the 1986 tax law may have reduced the tax differential between equipment and structures, it did so in a way that increased the tax bias against all investment in business plant and equipment relative to other kinds of business and nonbusiness outlays. The analysis that supported the elimination of the investment tax credit and the reduction of depreciation allowances as a means of achieving a more level playing field for business investment was incorrect because it ignored the wide range of investments that corporations make in addition to outlays for equipment and structures.

A corporation is investing whenever it gives up current profits in the hope of increasing future profits. Spending money for new plant and equipment is the most obvious but not the only form of business investment. A firm is also investing when it spends money on advertising, or on improvements in customer relations, or on recruiting employees, or on research and development. A firm also invests when it reduces current prices to increase its market share and raise future profits.

But there is a key difference between investments in plant and equipment and the so-called "intangible" investments in advertising, customer good will, market share, and personnel. The outlays on equipment and structures are not immediately deducted from income but are spread over a number of years. In contrast, all of the other forms of investment are deducted immediately in calculating taxable income. The current tax law therefore imparts a significant bias in favor of doing the intangible investments and this bias was increased by the 1986 tax changes that increased the effective tax rates on equipment and structures.

The bias in favor of intangible investments lowers overall productivity because it diverts scarce corporate funds away from plant and equipment and into less productive forms of investing. Moreover, although investments in advertising and market share may eventually raise the earnings of the investing corporation, that extra profit comes largely at the expense of other companies. National output and productivity are not increased.

A Cashflow Business Tax

In short, we have a tax system that distorts both the way that corporations finance themselves and the investments that they make: too little equity and too much debt coupled with too little investment in plant and equipment and too much investment in advertising, customer relations and market share.

There is a tax reform that would simultaneously eliminate both of these distortions: the cashflow business tax. It would change our current corporate tax rules in two important ways. First, interest payments would no longer be deductible. Second, all investments in plant and equipment and in inventories would be immediately deductible. The tax is called a "cashflow" tax because it is levied on the company's cash revenue minus all cash expenses (including investment but excluding the company's payments to the providers of its equity and debt capital).

Eliminating the deduction for interest would put debt and equity on an equal footing and eliminate the current tax bias to use excessive debt. The immediate expensing of all investments in structures, equipment and inventories would put such investments on a level playing field with advertising, personnel training, and other "intangible" investments for which current tax law already permits expensing.

The Cashflow Business Tax would thus eliminate the two most important distortions caused by our current business tax rules. Also eliminated would be the complex regulations defining the differences between debt and equity and spelling out the depreciation provisions for different types of assets.

What about the revenue effect of such a change? I have not done a detailed calculation. But some rough estimates indicate that the revenue gain of eliminating the interest deduction would just about pay for the revenue cost of immediate expensing of all investment. The overall change in tax rules could therefore be kept revenue neutral by a small change in the corporate tax rate.

There would of course be transition problems and special issues in dealing with financial corporations. But the shift to a Cashflow Business Tax would produce a simpler, fairer and more efficient tax system.

This committee might quite reasonably decide that the increase in corporate debt that has motivated these hearings does not present a substantial danger to the stability of our economy and therefore that, despite the serious distortions to business finance and investment caused by existing tax rules, America has had enough tax reform for one decade. But if you decide that the tax bias in favor of debt and against investment in plant and equipment should be eliminated, I strongly recommend that you consider the Cashflow Business Tax.

Chairman **Rostenkowski**. Mr. Friedman.

STATEMENT OF BENJAMIN M. FRIEDMAN, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MA

Mr. **Friedman**. Thank you, Mr. Chairman. I am grateful for the opportunity to discuss with this distinguished committee a set of issues that I think are of very serious importance, not only for the financing market but also for the health and vitality of our economy as a whole. Rather than read my testimony verbatim, I would prefer simply to summarize the highlights, if I may, sir.

Chairman **Rostenkowski**. Without objection, Dr. Friedman, your entire statement will be included in the record.

Mr. **Friedman**. Thank you, sir. I would like to address three questions. First, what is happening in regard to corporate reorganizations in the financial markets?

Second, is this a problem, and if so, why?

And third, to the extent that it is a problem, what, if anything, should Congress do about it?

I think we can be brief in talking about exactly what is happening. The phenomenon that has affected the United States financial markets throughout the last 4 years has been a massive substitution of debt for equity in corporate capital structures. Corporations are borrowing, not for the purpose of putting in place new productive assets. Their investments in new plant and equipment and machinery and research are down, compared to the national income. Rather, they are substituting debt for equity on the other side of their balance sheets. As a result, corporate net worth—that is, corporate assets minus corporate liabilities—has sharply declined as a share of national income. More troubling yet, corporations now face steadily increasing interest burdens. Even though interest rates are down and profits have recovered since the 1981–82 recession, corporate interest burdens have not fallen. Today it still takes more than 50 cents of every dollar of corporate earnings—measured before interest and taxes—just to pay the interest due each year. That is compared to an average of 16 cents on the dollar in the 1950's and 1960's, and an average of 33 cents on the dollar in the 1970's. Throughout the 1980's the corporate interest burden has been more than 50 cents on the dollar, and despite 7 years of economic expansion and recovery, that burden is not declining.

Is this a problem? And if so, why?

I believe that it is a problem, a potentially very serious one. The reason is the extent to which this increased interest burden at the corporate level has exacerbated the financial fragility of the American economy. By financial fragility, I mean the risk of a cumulative default experience, in which a default or bankruptcy by one borrowing firm leads, in turn, to difficulties either at its creditors or at its suppliers, so that firms that are in essentially sound business positions wind up themselves facing either defaults or bankruptcies.

If we look at the debt position of the average American corporation, I think it is clear that the issue of potential cumulative default is identical to the question of whether there is a recession. If earnings continue to grow, I see no difficulty in the average corporation's continuing to sustain its interest service. But if earnings don't grow continually—and, after all, what a recession means is that the average firm's earnings go down—then I believe that an unusually large number of American corporations will face either default or bankruptcy procedures.

At this point we can raise two questions. First, what do we make of the fact that, while corporate leverage in the United States has increased dramatically during the 1980's, it remains low compared to leverage abroad? The differences between our institutional arrangements including both the structure of financial institutions and also how our corporate shareholders and creditors own corporate liabilities and equity, and, for example, the Germans and Japanese, mean that direct comparisons are not apt. We simply do not know to what extent our markets with our different structure, our different institutions, our different shareholder arrangements, can sustain the kinds of leverage that are commonly held abroad.

Second, what about the claim, which we used to hear with great frequency, that interest burdens at the corporate level are high compared to today's earnings, but not compared to likely future earnings? That was an interesting idea up until about 15 months ago, but the stock market crash in October 1987 changed all that.

If I can direct your attention to figure 3, which follows page 10 of my testimony, I have calculated and plotted here the debt-to-equity value of American corporations based not on book value, but rather on market value for the equity. The importance of using market value is that the stock market price might well be a good indication of what people expect future earnings to be. If interest burdens were low compared to expected future earnings, therefore that would probably result in a low rather than a high debt-equity ratio.

As you can readily see from figure 3, up until October 1987 the idea that the market value debt-equity ratio was continually improving was approximately correct. But the crash changed that. I have calculated the market value debt-equity ratio based on the closing prices on October 19, 1987, and again for yearend 1987 and again most recently, for yearend 1988. The main conclusion is that market value debt-equity ratios have not improved, despite 7 years of economic expansion. We are essentially back where we were in the middle of the 1981–82 recession. Therefore, there is no ground for concluding that debt levels are high relative to today's earnings, but not relative to likely future earnings.

What conclusions should we draw? I think there are two possible conclusions. The first is that, if a recession comes, the risk of financial fracture is greater than we have known in the post-World War II period in this country.

But second, because recessions in the United States don't come automatically, there is another potentially worrisome conclusion. It is that, in deciding how to conduct monetary policy, the Federal Reserve System is likely to be severely constrained by the risk that, if we have a recession as part of the next round of tight money aimed at heading off price inflation, that recession is likely to have consequences unlike those in the past. In short, the tradeoffs between arresting price inflation on the one hand and forgone incomes, jobs, capital formation and so on, on the other, have shifted. It is implausible to expect that our monetary policymakers will continue, in the face of these changed tradeoffs, to act in the same way that they would have before. The ability of monetary policies to be effective in combating the next round of price inflation has, I believe, been compromised.

To conclude, what should Congress do about this problem? Although its precise contribution to the corporate reorganization movement is not known, it is clear that the tax incentive, which other witnesses testifying before this distinguished committee have already mentioned, is an important factor in this regard. This is, to be sure, nothing new. We have all known for a long time that the United States Tax Code has a sharp bias toward debt financing, and away from equity financing, at the corporate level. There has always been a need for the Congress to do something about this bias. The corporate reorganization movement now provides yet an additional reason to do so.

Numerous proposals have been offered in this regard. I would suggest that, in considering these, Congress take account of three general principles: Principle number one, of course, is that the cost of debt and equity finance should be equalized. But principle number two—and this is where we begin to rule out some of the more familiar options—is that this equalization should be effected in a way that does not, at the margin, raise the cost of capital for corporations financing new investment.

Many of our country's economic problems today stem from the fact that the share of our national income that we are devoting to net investment in business plant and equipment and machinery has fallen in the 1980s to a post-World War low. As a result, we are now seeing very disappointing progress in productivity growth, and real wages are actually falling. We have heard a great deal, especially during the recent election campaign, about how this is the longest-running economic expansion in United States peacetime history. What nobody bothers to mention, however, is that this is also the first economic expansion in 50 years in which the average working American is seeing his real wage go down. People are losing ground, even in a time that we are supposed to think of as prosperity.

As a result, we need more investment, not less, and therefore in addressing the problem of debt versus equity financing Congress should be especially careful not to raise the overall cost of corporate capital. That rules out several of the simpler options, like merely deleting interest deductibility.

And third, given the severe nature of our budget problem and the fact that the Federal Government's deficit is absorbing three-fourths of our Nation's net saving, we should not introduce new tax legislation that will be a large revenue loser. Unfortunately, that, too, eliminates several of the more familiar options. But it is important to point out that it also probably eliminates the option of doing nothing. If Congress does nothing, and allows the corporate reorganization movement to continue, slowly but surely the corporate tax base will erode. So I think that Congress should address the problem. It should equalize the cost of debt and equity finance, but do so in a way that takes account of these two other considerations.

Finally—and I here stray to an area that I realize lies beyond the purview of this particular committee—it is also now time to revisit many of the regulations that restrict financial institutions' ability to hold equity securities. Surely one of the rationales motivating the corporate reorganization movement has been the desire to design securities that in effect are equities, but that are disguised as debt, so that institutions that are formally prohibited from owning equity securities—or institutions that are restricted to allocating no more than, for example, 10 percent of their portfolios to equity securities—can load up on equities through the back-door vehicle of junk bonds and similar instruments. To the extent that these regulations are serving no purpose, Congress should eliminate them. To the extent that these regulations do have a purpose, then Congress should recognize that they are being thwarted and act to strengthen them.

Thank you very much, Mr. Chairman, for the opportunity to present my views to the committee.

[The prepared statement follows:]

January 31, 1989

TESTIMONY BEFORE THE UNITED STATES CONGRESS

HOUSE OF REPRESENTATIVES

COMMITTEE ON WAYS AND MEANS

Benjamin M. Friedman
Professor of Economics
Harvard University

Mr. Chairman:

I am grateful for the opportunity to present my views to this committee, as it considers potential public policy reponses to the growing corporate debt problem in the United States.

The burst of yet-again-record-size corporate takeovers in the fall of last year, including especially the $25 billion leveraged buy-out of RJR Nabisco, has heightened concerns about how the massive substitution of business debt for equity that has been under way for much of the 1980s will affect the American economy. During 1984-87, U.S. corporations in nonfinancial lines of business alone paid down more than $300 billion of equity through mergers, acquisitions, leveraged buy-outs and stock repurchases. Transactions closed during 1988 will add at least another $100 billion to that total, and there is no reason to predict that the process will end any time soon.

In my testimony this afternoon, I shall address several important questions that are likely to be central to the committee's discussion of these ongoing developments: What does all this huge-dollar buying and borrowing mean? Is the resulting increase in corporate indebtedness a problem? If so, why? More importantly, from a public policy perspective, what (if anything) should Congress do about it?

Dimensions of the Problem

American businesses are hardly alone in having borrowed in record volume in the 1980s. As Table 1 shows, since 1980 all major sectors of the U.S. economy except farms have increased their outstanding indebtedness at a pace significantly faster than the economy's overall growth. The huge budget deficits that became the hallmark of U.S. fiscal policy under the Reagan administration led to the first sustained peacetime increase in the federal government's debt, compared to national income, since the founding of the Republic. State and local governments have also increased their combined indebtedness, relative to national income, although their borrowing has clearly slowed since 1985 (presumably because of new tax legislation). Households -- mostly individuals, but also including personal trusts and non-profit organizations -- have likewise borrowed record amounts, although this trend too has slowed since the middle of the decade. Only among nonfarm businesses has the rise in indebtedness continued to accelerate.

The across-the-board rise of debt relative to income that has occurred in this decade has marked a sharp departure from prior patterns of U.S. financial behavior. Indeed, one of the most striking features of America's financial system from the end of World War II until the 1980s was the stable relationship between debt and economic activity. During this period the outstanding debt of all U.S. obligors other than financial intermediaries fluctuated within a narrow range, with no evident trend either up or down. Indeed, the overall debt-to-income ratio was especially stable from the end of the Korean War until the 1980s, averaging $135.70 of debt for every $100 of the nation's income during 1953-80. At yearend 1980, the total debt outstanding amounted to $137.10 for every $100 of income, virtually unchanged. By midyear 1988, however, the corresponding level was $179.30, greater than any prior U.S. debt level recorded in this century except for 1932-35 (when many recorded debts had defaulted de facto anyway).

This testimony draws heavily on my recent research, including "Increasing Indebtedness and Financial Stability in the United States" (Federal Reserve Bank of Kansas City, Debt, Financial Stability and Public Policy, 1986), "New Directions in the Relation Between Public and Private Debt" (Science, 24 April 1987), and "The Corporate Debt Problem" (Curry Foundation, Economic Vulnerabilities: Challenges for Policymakers, 1988).

As is clear from Table 1, roughly one-third of this increase is due to the mounting indebtedness of the federal government. This phenomenon has attracted widespread discussion, and rightly so -- not because the U.S. government is likely to default on its debt, but because the unending stream of unprecedented federal budget deficits behind it has absorbed approximately three-fourths of all net saving done in the 1980s by individual Americans and American businesses combined. As a result, this decade's net investment in business plant and equipment has represented a smaller share of national income than in the 1950s, or the 1960s, or the 1970s. In addition, the link running from budget deficits to interest rates to exchange rates caused the dollar to be substantially overvalued for most of the 1980s, thereby severely impairing U.S. international competitiveness -- and, along the way, transforming America from the world's foremost lending country to its biggest borrower.[1]

Private-sector borrowers, including both individuals and businesses, have accounted for the other two-thirds of the increase in total debt outstanding from $137.10 per $100 of income in 1980 to $179.30 in 1988. This phenomenon too has generated widespread concern. Here, however, fears of potential default have been paramount. In particular, discussion at a variety of levels has questioned whether a cascade of defaults by private-sector borrowers, initially touched off by some external shock -- a collapse of oil prices, for example, or a sharp rise in interest rates needed to defend the dollar -- might threaten the nation's financial system, or perhaps even the nonfinancial economy.

At least until the latest wave of corporate take-overs, popular discussion of this issue devoted more attention to consumer debt, exploiting the myth of the "me generation" to highlight (and often exaggerate) how much individuals have borrowed. But while it is true that both households and businesses have borrowed in record volume during the 1980s, on the whole they have done so for different purposes. Households have built up record debt levels relative to their incomes, but at the same time they have built up record asset levels, including not just equities and other assets exhibiting high price volatility, but also liquid assets and other stable-price debt instruments. As a result, aggregate-level household net worth has shown no significant deterioration compared to national income since 1980, and that remains true after the October 1987 stock market collapse. As of mid-year 1988, the net worth of the household sector (with liabilities and debt assets valued at par, reproducible tangible assets valued at reproduction cost, and land valued at market) was $15.1 trillion, or $312.10 for every $100 of national income. Comparable values from the past were $313.60 for every $100 of national income in 1980, and $306.10 in 1970.

By contrast, during the 1980s American businesses have increasingly borrowed not to invest, in either tangible or financial assets, but simply to pay down their own or other businesses' equity. As a result, the aggregate net worth of both the corporate sector and the noncorporate business sector has declined not just compared to national income, but absolutely.

Table 2 shows the aggregate balance sheet of the U.S. nonfinancial corporate business sector, for broad categories of assets and liabilities, with values for each year expressed as percentages of that year's national income. As of yearend 1987, the corporate sector's holdings of *financial* assets stood in roughly the same relation to national income as in 1980, but holdings of *tangible* assets, like plant and equipment, had declined -- the consequence of nearly a decade of fiscal policies that impeded business capital formation. At the same time, the corporate sector's outstanding debt had risen sharply from the fairly stable trend that had prevailed until 1980. (The appearance of a decline between 1970 and 1975 in corporate debt compared to gross national product reflects a statistical discontinuity in the data for trade debt.) With assets down but debt up, corporate net worth has fallen sharply compared to national income. At least as of 1987 this decline had not quite returned the corporate sector's net worth to the same income as prevailed in 1970, but the comparison is hardly reassuring. While 1987 was a year of economic expansion and full employment, in 1970 the economy was in recession.

Table 3 shows the analogous but even more severe (in percentage terms) deterioration among noncorporate businesses. In contrast to corporations, noncorporate business on average did modestly increase their holdings of both financial and tangible assets, compared to national income, in the 1980s. But because they increased their outstanding debt so much faster, their net worth too has declined compared to national income.

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[1] I have treated the sources and implications of the 1980s budget deficit at length in *Day of Reckoning: The Consequences of American Economic Policy Under Reagan and After* (Random House, 1988).

Why Is This Happening?

There is no lack of ready explanations for American businesses' eagerness to take on debt. To begin, the U.S. tax code penalizes equity finance, and correspondingly favors reliance on debt, by treating interest payments as a cost of doing business and therefore allowing borrowers to deduct them from taxable income. At the same time, interest and dividends are treated alike in the taxation of income earned by their recipients. Hence the total tax imposed on distributions of business earnings depends crucially on the debt-equity mix of the firm's capital structure.. This discrimination is all the greater in that borrowers can deduct the full (nominal) interest that they pay, including not just that part corresponding to the "real" interest rate but also the part that compensates the lender for the erosion of principal value due to inflation. In an economic sense, therefore, borrowers can and do deduct a part of what amounts to repayment of debt principal.

In addition to the nonneutrality of the tax code, other features of the U.S. financial system also favor reliance on debt. Legal and regulatory restrictions on ownership of equities by different kinds of financial intermediaries create an incentive to fashion instruments (like "junk" bonds) that have risk and return properties similar to equities but nonetheless constitute debt in the eyes of the relevant authorities. Larger underwriting spreads for equity offerings than for debt offerings further increase the incentive to rely on debt when firms seek new capital. The greater speed at which firms can raise new debt than new equity is also important in contexts like unsolicited take-overs, in which timing can be all-important.

What is puzzling, however, is why the explosion of business debt is occurring now. Each of these features of the U.S. financial system, which create a basic tendency toward debt financing, has been present for a long time. Indeed, some are less potent now than they were in the past. The lowering of tax rates in the 1980s, for example, should have reduced the incentive to borrow. So should the slowing of inflation. Yet the use of debt by American businesses has clearly increased. At least for the present, the most honest approach to the question of why all this is happening in the 1980s is to admit that nobody really knows.

Why Does It Matter?

Much of the concern aroused by this massive increase in business indebtedness stems from the fear that it will make the American economy excessively fragile in the face of some downward shock. This fear in turn reflects the fundamental two-way interrelationship between debtors' distress and contractions in economic activity. On one side, the chief economic danger posed by an overextended debt structure is that the failure of some borrowers to meet their obligations will lead to cash flow inadequacies for their creditors -- who may, in turn, also be borrowers, and so on -- and that both borrowers and creditors facing insufficient cash flows will then be forced to curtail their spending. Similarly, forced disposal of assets by debtors and others facing insufficient cash flows will lead to declines in asset prices that erode the ability of other asset owners to realize the expected value of their assets if sale becomes necessary, and will therefore threaten the solvency (in a balance sheet sense) of still others. This process, running from financial constraint to nonfinancial contraction, has long been familiar in the analysis of business downturns.

At the same time, the likelihood that a large-scale problem of debtors' distress will arise in the first place is clearly not independent of what is happening in the economy. Apart from occasion instances of recklessness, incompetence, or fraud, most borrowers typically expect to be able to service their debts in a timely fashion. In other words, they expect that their available cash flows -- and, if necessary, the value of their salable assets -- will be sufficient to meet the sequence of payments due. For most borrowers, however, both the size of cash flows and the value of marketable assets depend to a great extent on prosperity or recession in the economy at large. In particular, business downturns typically shrink the earnings of many firms, slow the growth of earnings for most others, and in many cases also reduce the market values of assets.

Hence problems of financial instability are most likely to erupt in the context of just the kind of economic difficulty that they tend to aggravate. Limitations on businesses' activities arising from widespread financial distress restrict economywide demands for goods and services, and for labor and capital inputs, and thereby depress overall economic activity. At the same time, a contraction of economic activity is the most likely initial cause of widespread debtors' distress in the first place.

Figure 1 gives a sense of how exposed to this kind of interaction the American economy has become, by showing the ratio of interest payments to available earnings (defined as the sum of interest and earnings before taxes, with both calculated from the National Income and Product Accounts) for the corporate and noncorporate parts of the nonfarm nonfinancial business sector. For purposes of comparison, the figure also shows the analogous ratio (interest payments to pre-tax personal income) for households.

The deterioration in the corporate sector's interest coverage is especially striking. Since 1980 it has consistently taken more than fifty cents of every dollar of pre-tax earnings just to pay corporations' interest bills. Further, in contrast to noncorporate businesses, the corporate sector's problem in this regard is not getting better as the economic expansion advances. Continuing large-scale borrowing has about offset both the effect of continuing economic expansion in boosting earnings and the effect of declining interest rates, so that corporations' interest coverage has remained poor throughout the decade to date.

Figure 2 presents an alternative perspective on corporate borrowers' ability to meet current obligations by plotting the ratio of interest payments to available cash flow (defined as the sum of earnings, as in Figure 1, plus depreciation, again calcuated from the National Income and Product Accounts), for the corporate sector only. The inclusion of depreciation lowers the relative interest burden throughout this period, of course, but it still shows little improvement since the end of the 1981-82 recession. Despite six years of economic recovery and expansion, the average corporation's interest burden remains very large by historical standards. It is not surprising, therefore, that the current business expansion has been the only one since World War II (the only one ever?) to bring with it a rising, rather than falling, rate of business bankruptcies and debt defaults.

Until the October 1987 stock market crash, a familiar answer to all this was that debt levels and interest burdens were high compared to current earnings, but not in relation to the earnings that American business was likely to enjoy in the not-very-distant future: that the American economy had entered a new era of stability and rapid growth, which soon enough would deliver the higher earnings needed to service the debts of all but the usual small percentage of corporations that are obviously mismanaged or extraordinarily unfortunate. The natural evidence to which to point in support of this more optimistic view was the high and rising level of stock prices, which provided at least one plausible estimate -- some would say the best available estimate -- of what those future earnings would be.

The crash changed all that. Figure 3 plots the ratio of debt (at book value) to equity (at market value) for the nonfarm nonfinancial corporate business sector. The solid line through yearend 1986 indicates yearend values of the debt/equity ratio calculated directly from the Federal Reserve's Flow-of-Funds Accounts. The value shown for yearend 1987 is also calculated directly from that source. The figure also shows two additional points for 1987 -- the August 25 stock market peak, and October 19 -- based on an interpolation of the quarterly Flow-of-Funds corporate borrowing data, in conjunction with a simple equation that relates the Standard & Poor's stock price index (published daily, of course) to the Flow-of-Funds estimate of the market value of equity for the entire nonfarm nonfinancial corporate business sector. Finally, the figure also includes a value of the debt/equity ratio for yearend 1988, based on an extrapolation of the pace of corporate borrowing during the first half of last year, and closing stock prices for last December 30.

The resulting picture speaks for itself. In short, the principal basis for the optimism about corporations' debt burdens in relation to likely future earnings that was often expressed just a brief time ago has now disappeared.

Yet another line of argument downplaying the significance of the great increase in American business indebtedness in the 1980s has emphasized the fact that, even today, most U.S. corporations remain less highly leveraged than their European or Japanese counterparts. If businesses elsewhere can sustain much greater debt burdens, the reasoning goes, why cannot ours?

Simple comparisons between corporate capital structures here and abroad fail to take into account differences in the institutional, legal, and philosophical environment that are potentially of great significance in this context. Foreign financial markets and financial institutions are typically structured very differently than ours. The ownership of corporate debt and equity securities is typically more highly concentrated than it is here, and -- unlike in America -- major lenders are also often major equity holders in the businesses to which they lend. As a result, the entire relationship between the financial sector and nonfinancial industry has a sharply different character. At the same time, foreign attitudes toward competition versus cooperation (or even cartelization) within industry have traditionally differed from ours. So have attitudes toward the relationship between the private sector as a whole and the government, including in particular the willingness of both financial institutions and nonfinancial firms to accede to various forms of governmental guidance. In some cases, a close corollary of this willingness has been a different set of presumptions about the government's readiness to intervene, if necessary, to rescue distressed private firms.

No one knows just how important any or all of these differences have been in accounting for the historically higher leverage of European and Japanese businesses. Much systematic research needs to be done on such questions. The findings of that research may indicate, for example, that specific changes in our own legal and institutional structures would be useful, in that they would then permit U.S. corporations safely to adopt debt burdens more nearly comparable to those abroad. In the absence of such changes, however -- indeed, in the absence even of knowledge about just which differences between our institutions and those abroad are most important in this regard -- the simple fact that U.S. corporations' debt burdens have not yet risen as high as those of foreign firms is also not reassuring.

Implications of Higher Business Indebtedness

Two principal implications follow. First, in the event of a business contraction initiated by some entirely external factor -- for example, an international cartel action comparable to the oil price increases imposed by OPEC in 1973 and again in 1979 -- the American economy would exhibit less resilience, and correspondingly more proclivity to contractionary dynamics, because of the greater potential for financial instability.[2]

But second, to the extent that U.S. policymakers are aware of this potential instability, and to the extent that they can and do exert influence over the path of economic activity, the onset of a major business recession is itself less likely. Given the important role of monetary policy in bringing about each of the most significant postwar U.S. recessions, this implication for the likely future behavior of monetary policymakers is probably the more important of the two.

The main point is therefore that, because of the increased likelihood of debtors' distress in the event of an economic downturn, the Federal Reserve System is likely to be less willing either to seek or to permit a business recession in the United States. At the relevant margin of policy choice, U.S. monetary policymakers are likely to see the real costs of a business recession -- costs in terms of foregone output, incomes, jobs, capital formation, and so on -- as greater than would be the case without the higher level of business indebtedness. On average over an extended period, therefore, U.S. monetary policy is likely to be more expansionary than it would be in the absence of a higher debt ratio.

In light of the key role historically played by periodic episodes of tight monetary policy in either arresting or reducing price inflation, both in America and elsewhere, this likelihood of a bias toward more expansionary monetary policy on average, due to a greater reluctance to tolerate economic contractions, raises the prospect of inflation as the ultimate chief consequence of higher business indebtedness. The historical record makes clear that the restrictive monetary policy that figured so importantly in the major recessions of 1957-58, 1973-75, and 1981-82 (the three largest recessions of the postwar period) in each case arose largely out of Federal Reserve policymakers' desire to slow the then prevailing rate of price inflation. And in each case, the recession did accomplish just that end.

Although it is theoretically possible to achieve both price stability and steady real growth, without the occasional punctuation of economic downturns, nothing in the postwar America experience suggests that doing so is practically feasible. Instead, this experience suggests that if enlarged business indebtedness raises the cost of economic downturns, and hence makes policymakers less likely to accept them, it therefore also imparts an inflationary bias.

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[2] For an analysis based on individual company data, which largely confirms the conclusion drawn here on the basis on aggregate data, see Ben S. Bernanke and John Y. Campbell, "Is There A Corporate Debt Crisis?" (*Brookings Papers on Economic Activity*, No. 1, 1988).

To put the point in simple short-hand, the borrowing that American corporations and other businesses have done in the 1980s has shifted the short- and intermediate-run trade-offs confronting monetary policy, and it is implausible to expect Federal Reserve policymakers to respond to events as they would have had that shift not occurred. But if the reason why these enlarged debt burdens will not lead to debt deflation or worse is that they have effectively locked the Federal Reserve into a no-recession monetary policy, the record of inflation and business cycles since World War II gives little reason for confidence that the ultimate consequence of the corporate debt problem will not be the return of high inflation.

What Should Congress Do About The Problem?

The one obvious step that Congress can and should take to prevent yet further deterioration of this situation -- and, over the longer term, to encourage movement in the opposite direction -- is to correct the nonneutrality of the tax code between debt and equity financing. No one yet knows just how much of the "value" created by leveraged buy-outs and similar transactions results from merely extinguishing future corporate tax liabilities, but the tax code clearly provides strong incentives for such restructurings.

There are a variety of ways to eliminate this nonneutrality, ranging from disallowing the deductibility of interest payments (or perhaps just the deductibility of interest paid at rates above some benchmark), to explicitly recognizing the distinction between real and nominal interest rates, to granting some form of deductibility for dividends. Specific proposals offered in response to the recent growth of concern about this problem have also included a corporate cash flow tax, which essentially amounts to disallowing the interest deduction while allowing firms to expense their capital spending, and the more complex American Law Institute proposal, which is intended in part to ensure that any restructuring of a corporation's capital structure that extinguishes future tax liabilities at the corporate level simultaneously triggers a taxable event at the shareholder level.[3] (Mirroring the concern that tax incentives may be motivating transactions with little or no economic rationale is the concern that such transactions will reduce the ability of the corporate income tax to provide revenue to the federal government.)

Evaluating these and other possible courses of legislative action will require careful analysis, at both the substantive and the technical levels. I hope that as it proceeds, however, the committee will attach a high priority to two principles. First, in light of the poor record of U.S. capital formation during the 1980s, and the consequences of that record for the American economy's future ability to be both productive and competitive, Congress should avoid actions (like simply disallowing interest deductibility) that, on net, would further increase the total cost of capital to business. What is necessary is to equalize the after-tax cost of debt and equity financing by making debt more expensive and equity less so, not to raise the cost of capital overall. And second, in light of the major role that the burden of financing the U.S. Government's out-sized budget deficit has played in accounting for that poor capital formation record -- and also in light of the obvious severity of the challenge Congress now faces to narrow the deficit -- Congress should also avoid actions (like simply making dividends deductible) that would reduce revenues from the corporate income tax by large amounts without offsetting revenue increases in some other form.

Potentially constructive actions beyond tax reform are also readily apparent, but they mostly fall under the purview of regulatory authorities rather than Congress. Restrictions that prevent financial institutions from owning equities (or, as in the case of insurance companies in most states, limit their equity holdings to stated percentages of their total assets), yet permit ownership of high-yield high-risk bonds, serve no valid purpose at the level of the financial institution but create unwanted effects at the macroeconomic level. This situation is especially perverse in the case of financial intermediaries empowered to issue federally guaranteed liabilities. (For example, although savings and loan institutions in the aggregate hold less than 10% of all "junk" bonds outstanding in the United States, some three-fourths of the "junk" bonds held by all savings and loans institutions combined are held by just ten institutions.[4]) If restrictions on equity ownership serve a useful purpose at the level of the financial intermediary, the relevant authorities should strengthen them to prevent their being flouted by ownership of what amounts for this purpose to equity dressed up to look like debt. If these restrictions serve no such useful purpose, they should be abolished.

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[3] "Tax Advisory Group Draft No. 18, Subchapter C (Supplemental Study), Part I" (American Law Institute, November, 1988).

[4] See Robert A. Taggart, Jr., "The Junk Bond Market and Its Role in Financing Mergers and Acquisitions" (Auerbach, ed., Mergers and Acquisitions, University of Chicago Press, 1988).

Finally, measures directed more specifically at corporate debt incurred in the process of unsolicited take-overs -- which have proliferated with the latest new wave of large-scale transactions -- are of dubious value at this time. One reason is just the ease with which they can be avoided. The more fundamental objection, however, is that they would primarily serve to protect the interest of entrenched managements seeking at all cost to maintain corporate control. There is still insufficient experience to judge whether unsolicited take-overs do or do not advance business efficiency, growth, productivity, or any of a variety of other worthwhile economic objectives.[5] Until the evidence on such questions is in, actions that would have the effect of precluding these transactions do not constitute sound public policy.

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Thank you, Mr. Chairman, for allowing me to present my views to the Committee.

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[5] See, for example, the evidence reviewed in Michale C. Jensen, "Takeovers: Their Causes and Consequences" (Journal of Economic Perspectives, Winter, 1988).

TABLE 1

INCREASE IN THE U.S. DEBT RATIO, 1980-88

Borrower	Debt Ratio 1980	1985	1988	Change 1980-88
Households	50.2%	56.3%	61.1%	10.9%
Businesses	50.5	58.5	64.3	13.8
Corporations	29.1	32.5	37.0	7.9
Farms	5.7	4.2	3.0	-2.7
Other	15.7	21.9	24.3	8.6
State & Local Governments	10.3	11.6	11.8	1.5
Federal Government	26.1	39.0	42.0	15.9
All Nonfinancial Borrowers	137.1	165.5	179.3	42.2

NOTES: Figures for 1980 and 1985 are yearend totals of credit market liabilities, expressed as percentages of corresponding fourth-quarter gross national product (seasonally adjusted at annual rates).

Figures for 1988 are second quarter totals.

Detail may not add to totals due to rounding.

SOURCE: Board of Governors of the Federal Reserve System.

TABLE 2

BALANCE SHEET OF THE U.S. NONFARM CORPORATE BUSINESS SECTOR

	1960	1970	1980	1987
Total Assets	131.6%	126.6%	140.5%	130.1%
Tangible	96.1	90.7	104.9	93.5
Financial	35.4	35.9	35.6	36.6
Liquid	10.0	6.7	6.9	10.6
Other	25.4	29.2	28.7	26.0
Total Liabilities	46.4	52.1	45.1	53.1
Market Debt	30.0	34.2	29.1	36.3
Trade Debt	12.4	15.5	12.2	11.0
Other	5.0	2.4	3.8	5.8
Net Worth	85.2	74.5	95.5	77.0

NOTES: Data are yearend values, scaled by corresponding fourth-quarter gross national product (seasonally adjusted at annual rates).

Detail may not add to totals due to rounding.

Data for trade debt reflect a series break in 1974.

SOURCE: Board of Governors of the Federal Reserve System.

TABLE 3

BALANCE SHEET OF THE U.S. NONFARM NONCORPORATE BUSINESS SECTOR

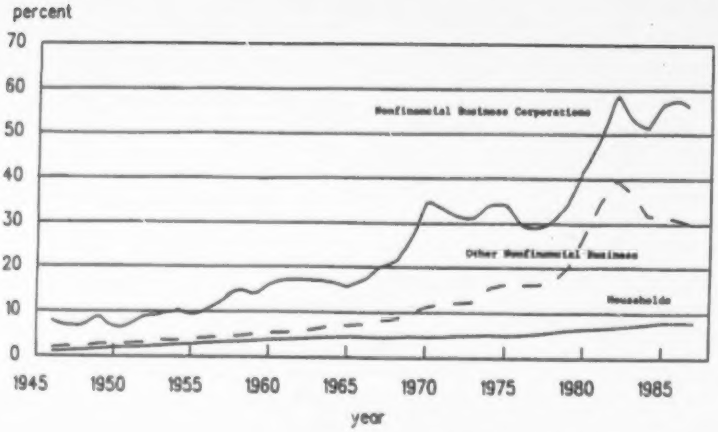
	1960	1970	1980	1987
Total Assets	52.3%	43.6%	60.9%	65.6%
Tangible	47.0	40.5	55.7	57.1
Financial	5.3	3.2	5.2	8.5
Liquid	2.4	1.2	1.1	1.7
Other	2.9	1.9	4.1	6.8
Total Liabilities	7.5	10.3	18.2	27.8
Market Debt	5.3	9.8	15.7	23.9
Trade Debt	2.2	0.5	2.5	4.0
Net Worth	44.8	33.3	42.7	37.8

NOTES: Data are yearend values, scaled by corresponding fourth-quarter gross national product (seasonally adjusted at annual rates).

Detail may not add to totals due to rounding.

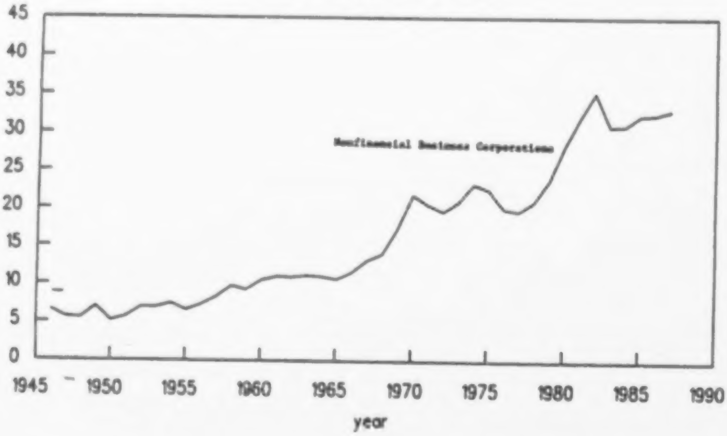
SOURCE: Board of Governors of the Federal Reserve System.

Figure 1:
Interest Payments As A Percent Of
Available Earnings, 1946 - 1987



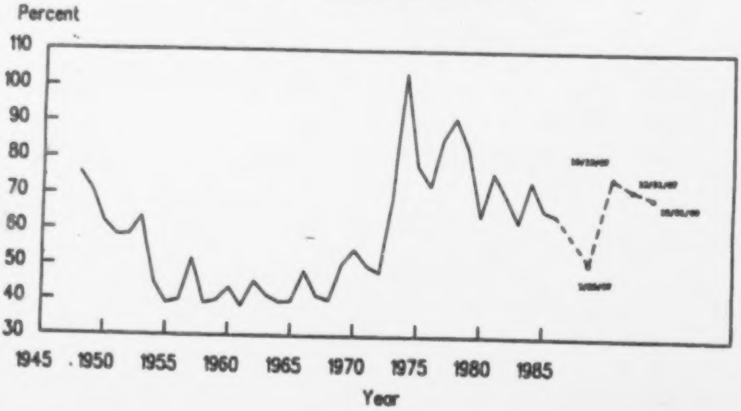
Source: Bureau Of Economic Analysis

Figure 2:
Interest Payments As A Percent Of
Available Cash Flow, 1946 - 1987



Source: Bureau Of Economic Analysis

Figure 3:
Market Value Debt-Equity Ratio, Non-Farm
Non-Financial Corporate Business Sector
1948-1986, and Selected Dates 1987-1988



Source: Board Of Governors of the
Federal Reserve System
Flow Of Funds Accounts,
and author's calculations

Mr. **Pickle**. Thank you, Dr. Friedman. Thank all you gentlemen for your testimony.

Let me ask Mr. Feldstein first a question: You have made a proposal to disallow the interest deduction, but allow a cash flow business tax. Give me an example of how you would have that work.

Assume that you would allow no interest deduction but you would allow immediate expensing of all investments. Give me an example of how that would work. What would you exclude in that formula? Can you do that?

Mr. **Feldstein**. Yes. I am not sure what the ambiguity is. I would allow a corporation to immediately deduct all of its outlays for new equipment, new structures, additions to inventories.

Mr. **Pickle**. Immediate deduction?

Mr. **Feldstein**. Yes. And it would not get any deduction for interest payments that it had on debt. In other words, interest payments would be treated like dividend payments. And equipment, structures and additions to inventories would be treated like wages and salaries, advertising outlays and so on.

Mr. **Pickle**. Now, have you made this suggestion to the Treasury?

Mr. **Feldstein**. Not in a formal way.

Mr. **Pickle**. Or to the IRS?

Mr. **Feldstein**. No.

Mr. **Pickle**. Or to anyone else?

Mr. **Feldstein**. I am making it to the distinguished Committee on Ways and Means.

Mr. **Pickle**. We are the first to learn of this proposal, then?

Mr. **Feldstein**. You are the first committee to which I have made the proposal.

Mr. **Pickle**. I am not belittling your recommendation. It is just a novel way to go at it.

Mr. **Feldstein**. It is a way, I might add, that economists, many economists have considered in the past, and so it is not something novel that just sprung up today.

Mr. **Pickle**. It might be a different way to look at this. But you do not have any reaction from the powers down the street on this?

Mr. **Feldstein**. No, sir.

Mr. **Pickle**. All right.

Now, let me ask Mr. Rohatyn, you said that we could control the advantage foreign companies might have if we took away the interest deduction from our own companies. You seem to indicate that this may not be a problem—because they are in many cases subject to the same tax treatment. You indicate we could put them on an even footing by another means.

I don't understand how we could do that. Could you explain that further to me?

Mr. **Rohatyn**. What I was trying to say is that I didn't think that looking at the certain amount of limiting tax deductibility in the junk bond area or in the acquisition area would terribly disadvantage American companies vis-a-vis foreign companies, since I believe most foreign companies don't have debt-to-equity ratios that are as extreme as ours, nor do I believe that they pay as high interest rates as ours.

So that if, for instance, you were to take a junk bond paying 16 percent interest and said 4 percent of that interest was nondeductible, which left 12 percent as a deductible interest, I think that is probably competitive with what foreign companies pay for their money.

I am just giving you my own feeling. I do believe that there are areas where American companies should be put on an even footing with foreign companies, and that is probably more in the accounting area than necessarily in the tax area.

Mr. PICKLE. That is what I want you to tell me. How does the change in accounting revenues make the playing field level?

Mr. ROHATYN. Take an American company acquiring another company, say for $10 billion, that has a net worth of $2 billion. That $8 billion difference is treated as goodwill and has to be amortized at most over 40 years, and depending on the business, may be shorter.

So that would be about $200 million a year, at least, of an after-tax charge to earnings. A number of foreign countries don't require that treatment, and some countries, you can just charge all the goodwill to surplus immediately, and don't have the charge to earnings which gives a foreign company a big advantage in terms of reporting profits as opposed to the American economy.

Now, these are accounting standards set by the SEC and by the Accounting Standards Board.

Mr. PICKLE. And if we could follow your course, we wouldn't need legislation; just make regulatory changes down the street?

Mr. ROHATYN. Yes.

Mr. PICKLE. Have you proposed that to Treasury?

Mr. ROHATYN. Well, to the Treasury, this has no tax impact.

Mr. PICKLE. It is not new? What do you think their reaction would be?

Mr. ROHATYN. Of the accounting profession? We have been fighting with them for years over this, for years. And there are as many treatments of goodwill as you can shake a stick at, but we haven't been at all successful in changing that.

Now, the truth of the matter is that foreign acquisitions haven't become as prevalent or have become much more prevalent recently, and maybe this is an issue that we should revisit.

Mr. PICKLE. Perhaps, of course, if they have been discussing this and arguing this and debating this for some time and have done nothing, it is not likely that they will reach an agreement now or listen to us if we recommend to do something.

Mr. ROHATYN. I am always hopeful for wisdom, especially coming from the Congress.

Mr. PICKLE. Well, I would like to hope that we would have that "la fuerza," but I don't know that we do. It is something that we can look forward to. Can you give me another suggestion as to how to do away with the so-called bridge loans? You say it is a phenomenon that developed as sort of an in-between facility until junk bonds can come into play. Are you recommending that we do away with bridge loans?

Mr. ROHATYN. No, sir. What I am recommending is that these bridge loans be financed with permanent capital to a much greater extent than has been the case presently when they are financed with the sale of 30 or 60-day commercial paper, so that if something goes wrong and the bridge turns out to be longer than people thought, because some day, the junk bond market may not be there to refinance it, the securities firm not be there, having to—having to permanently finance a long-term investment with short-term paper.

I just think that the capital requirements to do this should be increased significantly in order to make it a safer structure.

Mr. PICKLE. Are banking institutions more responsible for the bridge loans than anyone?

Mr. ROHATYN. I beg your pardon?

Mr. PICKLE. Are the banks——

Mr. ROHATYN. The investment banking houses, yes, sir.

Mr. PICKLE. They are not trying to hold back on it? They are encouraging them? They use it?

Mr. ROHATYN. They use it very aggressively. It is a very profitable business.

Mr. PICKLE. I thank you very much.

Let me ask, Mr. Shaw, do you have any questions, Mr. Shaw?

Mr. SHAW. Yes, I have one question that I want to pursue with Mr. Friedman regarding the breakdown in capital investment here in this country. We have heard, Mr. Feldstein, a very unique, at least to me, and evidently from the comments on this committee, unique type of suggestion as to how we could perhaps stimulate investment by simply allowing the write-offs as investments were made.

Would you care to comment on his idea and what you might have thought of it?

Mr. FRIEDMAN. I think it is a good idea, one of a variety of proposals that are in the air that have a dual purpose. One purpose is to redress the balance of corporate debt versus corporate equity financing, regardless of what the level of corporate investment happens to be.

The second—and, frankly, I think even more important—purpose is to encourage corporations to undertake new additional investment. I think one of the great disappointments of the 1980's has been the extent to which, despite massive cash flows to American corporations, we have seen a very disappointing investment performance. An advantage of devices like the cash flow business tax is that it encourages corporations to devote more of their resources to investment in productive plant and equipment, and correspondingly less to other activities, than they otherwise would do under the current Tax Code.

In this respect, I might say that the loss of provisions like the investment tax credit and like some of the liberalized depreciation, that were eliminated or weakened in the Tax Reform Act of 1986, went in the wrong direction from this perspective. Something like the cash flow business tax, or a variety of other proposals, would help to redress that problem.

Mr. SHAW. Are you pinpointing the demise of the investment tax credit as a cause of the decrease in investment and capital?

Mr. FRIEDMAN. Not yet, sir. That happened only with the legislation of 1986.

Mr. **Shaw**. So you are saying this has taken hold even when the investment tax credit was in place? This whole trend?

Mr. **Friedman**. Yes, sir, that is right. I think the primary reason is the Federal Government's borrowing, which has absorbed three-fourths of all the net saving that American families and businesses have combined on average throughout the 1980's. That means that this saving hasn't been available to be devoted either to business investment in machinery and plant, or to new housing, or to net foreign investment.

Mr. **Shaw**. We get inundated with statistics here. This morning, we listened to the Treasury Secretary, showing that the amount of the annual deficit was some 3-point-something percentage of the GNP, which was very low. He said if you put on top of that municipal and other type of government borrowing throughout the system that here in this country we are very low.

But now you also have quoted a statistic we have heard before, too, on how much the country is absorbing. Can any of the three of you tell me exactly how this lines up?

Mr. **Friedman**. I think so, but if I may ask, sir, because I wasn't here when Mr. Brady spoke, was the point of his statement that our Federal deficit is low compared to what it is in other countries?

Mr. **Shaw**. When you speak in terms of a percentage of the Gross National Product.

Mr. **Friedman**. He is exactly correct, sir. But the problem is that the United States is, and always has been, a low saving country. In Japan, for example, to take the most popular comparison, the Government deficit compared to Japanese national income has been averaging in the range of 6 to 7 percent. That is as much as ours was even at the bottom in the 1981–82 period.

But the difference is that, instead of having net private saving in the range of 6 to 8 percent, the way we do, the Japanese save something that ranges from, say, 16 on up to perhaps 22 percent of their national income, depending upon which measure one uses.

Because they save so much more out of their national income, they can have a larger government deficit and still have much more left over to invest in business. If we saved what the Japanese did, we could afford a larger government deficit and invest more, too.

Mr. **Shaw**. A question, then. If we level out the differences between equity financing and debt financing and make it less attractive to borrow money, aren't we then going to cut down some of the demand for the savings that you are talking about, which might then decrease the desire to save? Or does that make any sense?

Mr. **Friedman**. No, sir, I don't think so. In the first place, there is little if any evidence that the desire to save in the United States is responsive to tax legislation. The only piece of tax legislation that I know of that appears to have affected saving behavior in the 1980's is the IRA provisions, which, unfortunately, we have now rolled back.

But if the corporate tax situation were such that corporations had a lower cost of capital, that would encourage them to invest more and therefore be able to pay a higher rate of return to investors, and perhaps—with emphasis on the perhaps—that might elicit more saving.

Mr. Shaw. Thank you.

Mr. Pickle. The time of the gentleman has expired.

Mr. Rangel.

Mr. Rangel. Thank you, Mr. Chairman.

Let me thank the entire panel, but especially my friend, Mr. Rohatyn, for his statement that cannot be described as self-serving. You tied up the dilemma that we find ourselves in in this country with the trade deficit and the domestic deficit, and it seems it hasn't been that long ago that we had broad-based support for the 1981 Economic Recovery Tax Act, and the whole theory behind that was that if we dramatically reduce the tax rates, the individual and corporate, that we would have a greater opportunity to have savings for investment and improve the tangible assets, plants and equipment, and that in turn was supposed to increase productivity and competition and increase profits and therefore, revenues, and therefore reduce the deficit.

What went wrong? Mr. Rohatyn.

Mr. Rohatyn. Mr. Rangel, I am, as you know, a member of the—if not defunct, rather ill—National Economic Commission, and we have been trying to determine what went wrong. I can't tell you what went wrong, something went very wrong, because what happened is that the savings rate didn't go up, investments didn't go up, and the national debt went up by $1.7 trillion.

And what I said to you earlier in my testimony I believe in very, very firmly, I think the name of the game for a country, for a developed western power, is a hard currency, low interest rate, high rate of investment, and the ability to export capital.

We are doing just the other way around. And as Professor Friedman said, the issue here isn't just the level of our deficits, but at the same time, the low level of savings and the high level of our interest rates and the tremendous investment needs for this country which are remaining frustrated. Everything I see in terms of business activity and corporate activity is going in the wrong direction, because that is being rewarded today is not long-term investment and fundamental investment, but short-term financial restructurings.

And I don't think this is a way for a strong industrial power to behave. It isn't the way the Japanese behave or the way the Germans behave.

Mr. Rangel. When President Reagan first presented this economic recovery package, it had broad-based business support, and this morning, Treasury Secretary Brady said, compared to the gross national product, the deficit was no threat, he didn't even really see where companies that relied on debt as opposed to equity in terms of their financing at this time proposed any major problem.

He said he would have to look to see whether the trend continued. I guess my question is that for those who relied so heavily on the business community and the economists in supporting the President in 1981, why does it appear to be such a silence now when obviously the game plan didn't work, and we find more and more of our budget being devoted to just paying interest on debt service? We don't find full-page ads in the Washington Post and the New York Times. It is as though everyone is expecting someone to do something, and yet the President says read his lips, and the business community just supports him.

Mr. ROHATYN. I would say that the business community as I know it, the boards of corporations where I sit, people from the Business Roundtable that I talk to, are very concerned about the deficit.

They are much more concerned than their public statements show. I believe they are supportive of the President's flexible freeze for the moment, because they think that the new administration should be given its chance, and they don't want to oppose it.

But I think that if you were to scratch beneath the surface as to the real feelings, you would find an enormous amount of concern for the national debt.

Chairman ROSTENKOWSKI. Mr. Downey.

Mr. DOWNEY. I agree with almost everything you have said in your statement, which assumes, as is historically the case, that one of us is doing all the thinking.

Mr. ROHATYN. It means that we will both be ostracized.

Mr. DOWNEY. I want to ask you about them. I think that clearly, all of these events are interconnected and need to be dealt with in that same way. You point out this is a time for the Cohen commission, and I think the National Economic Commission of which I was the author in the House is probably not going to accomplish what we would both like to see it accomplish.

I am not sure that the Cohen commission or something like it could do what we would like to do here. And given the limited parameters of choice that we face, and maybe all of the panelists, maybe the others can address this issue, I am going to ask you some narrowly focused questions, the ones that I put to the Treasury Secretary, because I think this is the limit of the game.

Does it make sense for us to limit by a small degree the amount of interest that people can deduct, say 90 percent, and take that 10 percent savings that would accrue to the Treasury and apply it to a dividend scheme? Either allowing a partial deduction for dividend or a partial credit for dividends just to try to even the playing field?

And further, would you be in favor of a proposal that would go back to the taxation of—well, not go back to, but would have withholding and interest in dividends to generate revenue for the purpose of applying it for a credit or some partial deduction for dividends paid?

Felix, if you would start?

Mr. ROHATYN. I think to answer your first question, I think that the nondeductibility of a small portion of the interest in order to finance dividend deductibility, I would want to see some really sophisticated economic models run on what that would produce and the impact of it, because you know, you know the budget deficit that we are facing in New York State, because we tried to estimate the impact of the 1986 Tax Reform Act, and we are $2 billion in the hole now as a result of that.

Mr. DOWNEY. Yes.

Mr. ROHATYN. So the answer is that I am not sure. What was your second question?

Mr. **Downey**. Assuming that you don't want to do that, my general inclination is that I am not yet convinced that I have seen enough facts. But if we are going to do something, we are going to have to have the revenue to do it.

Mr. **Rohatyn**. I would rather increase the tax on short swing profits.

Mr. **Downey**. Rather than withholding on interest?

Mr. **Rohatyn**. When you begin to hold dividends and on interest, first of all, you may be chasing away a lot of foreign-capital that is here. I don't know what the answer to that is, and second, you are taxing financial institutions that are now tax-free. That is a major step, because they don't have the credit to offset, and I think that is something that you would want to look at very, very carefully.

I would start with a small step, which is to tax short swing profits of anybody, including tax-free institutions, if they take profits on securities, say within 1 year and they act as security dealers at that point; and use some of that money either to reduce the tax, to give some kind of credit on dividends or, alternatively, have a sliding scale on long-term capital gains that go down with time, something like that.

Chairman **Rostenkowski**. Mr. Crane.

Mr. **Crane**. I want to commend this panel for their testimony. Mr. Friedman, are you related to Milton?

Mr. **Friedman**. No, sir.

Mr. **Crane**. I thought he had a son at Harvard.

Mr. **Friedman**. He did. David was 1 year ahead of me.

Mr. **Crane**. Since there is a fundamental contradiction between your suggestion on the deductibility of interest and that by Dr. Feldstein, it seems to me historically that we have attempted to put incentives or disincentives in the code to try to promote behavior modification, and historically we were a Nation of savers and investors, too, but my understanding is we skewed our Tax Code to get us out of the depression of 1929—we skewed the Tax Code toward consumption and simultaneously penalized savings and investment with the code with multiple hits, which the Japanese historically, until I think last year—they started taxing interest—did not do.

And for that reason, on the one hand, I like your recommendation, Professor Friedman, on not disallowing the deduction on interest payments, but on the other hand, I must say that Dr. Feldstein's proposal sounds very attractive to me, especially if it is roughly revenue-neutral.

Mr **Friedman**. Congressman, I was surprised that you thought there was a conflict. I said that I thought we ought not merely to disallow the interest deduction without offsetting that in some way that would leave the cost of capital to corporations at best no higher than it is today. If we merely eliminated interest deductibility, and let it go at that, then the average cost of capital to a corporation financing a new plant would rise.

But Professor Feldstein's idea is one of the useful ideas that would serve the purpose by simultaneously deleting the interest deductibility and going on to allow full immediate expensing of capital expenditures.

That would address the problem that I was concerned about. It would not have the effect of raising the overall cost of corporate capital used for investment purposes, and therefore I didn't think there was a conflict between my general idea and the more specific suggestion that Professor Feldstein raised.

Mr. CRANE. That was my misunderstanding then. Using the code in a way to promote certain kinds of behavior is to me eloquent with good sense and the fact of the matter is that historically throughout my lifetime, most of it—we have had this bias against savings and investment in this country.

And we have simultaneously provided great incentives for people to live beyond their means. We disallowed in 1986 some of the interest deductions for living beyond your means, for individuals, but it does seem to me that our code is decidedly biased.

The one thing that I say that you did not recommend, Dr. Feldstein, is, for example, eliminating taxation of dividends or lowering capital gains rates to maybe 15 percent which, based on our historic experience seems to me to be a good idea as a revenue-raiser and gaining venture capital.

But I confess that when we had President Reagan come lobby the Republican conference, which he did in December 1985, after procedurally the so-called Tax Reform Act had been defeated, President Reagan made his eloquent plea for all Republicans to re-evaluate and get behind it.

I raised a question with him at the time about his historic opposition to taxation of businesses anyway, that that represents a cost and it was a bad time to be escalating their cost. And he responded, and this is my impersonation of Reagan, "Well, Phil, I really believe that businesses don't pay taxes, but we feel for the time being this is the best we can get."

And that left my head swimming because I didn't quite understand what he was talking about and I still don't. But the sad fact is we did overburden business, it seems to me. And it could create the incentives, with the deductibility of interest of businesses to engage in the practices they are engaged in now.

So I would hope that the committee might in addressing this problem, look at your suggestions here, of perhaps building some incentives into making productive investments and increasing their productivity in plant and equipment and inventory.

I want to commend you for your testimony here and hope the committee listens carefully to it. Thank you.

Chairman ROSTENKOWSKI. Mr. Guarini.

Mr. GUARINI. Thank you, Mr. Chairman. It seems obvious that you can't look at the little picture without looking at the large picture of our economy becoming more competitive and how we can stabilize our fiscal picture. The idea that you have, Dr. Feldstein, is of course, excellent, but is that the same expensing out idea that this House passed about 9 years ago, but the Senate failed to pass. Where we allowed corporations over a period of maybe—5 or 10 years, to take whatever profits from their net income of their operating profits that year to layoff against the deductibility of the equipment and plant and other equipment that they had purchased that year?

Mr. FELDSTEIN. I don't think——

Mr. GUARINI. The idea of expensing out is something that this committee passed about 9 years ago. I agree with you that it helps our trade picture. It helps our overall health of the corporate equity and I am sorry that we lost track of it because I believe we have to come back to basics.

Of course, what you did, you coupled with the idea that you shouldn't take deductions for interest so that what you lose on income from one way, you pick up income the other way, so in a sense the numbers can match out? You can say it is revenue neutral.

Can you comment on that?

Mr. FELDSTEIN. I can't remember what the House passed 9 years ago. I didn't recall an expensing proposal at the time. But what this would do is to treat all forms of financing equally, debt and equity, and all forms of investment, both plant, equipment and inventory investment and intangible investment like advertising and so on, equally.

Mr. GUARINI. You wouldn't have a depreciation table for machinery and automobiles and things like that?

Some countries actually do that. Canada does that in steel. They allow you to take a steel plant off in 2 years.

Mr. FELDSTEIN. I would want to do it in general across the board.

Mr. GUARINI. It could help your industrial expansion and make us more competitive trade-wise.

Mr. FELDSTEIN. You should get the careful revenue estimates of this that your staff can produce and to ask what kind of adjustment would have to be made up or down in corporate tax rates to make the package as a whole revenue-neutral.

Mr. GUARINI. It would be a loss, but you would walk——

Mr. FELDSTEIN. During a transition, moreover, the impact depends obviously on what happens to borrowing outlays in the future, interest outlays of corporations. As the other witnesses have pointed out, we are clearly on a trend toward higher and higher levels of borrowing by corporations.

Mr. GUARINI. If you don't allow the deductibility of loans to a corporation, what impact would that have on an overall interest rate? Would that encourage them to borrow less?

Mr. FELDSTEIN. Well, this proposal would have two offsetting effects. On the one hand, the reduced demand for credit, reduced desire to borrow, would reduce interest rates but at the same time the increased demand to vest in new plant and equipment would push in the opposite direction.

So I can't, just sitting here, say what the net effect if any, would be on the overall rate.

Mr. GUARINI. I agree with you. It is the way to go and it could help to solve our LBO problem.

Mr. FELDSTEIN. It would clearly help to do that. Again, there are different kinds of LBO's, but it would remove the incentive for using debt that comes just from its deductibility rather than from the fundamental soundness of the activity itself.

Mr. GUARINI. Would it help the healthy companies that do have cash that they could write off against their equipment, whereas companies that are less healthy will find it even more difficult to operate because they can't take a deduction from their interest?

Mr. **Feldstein**. Right now, those companies that don't have taxable profits are not getting a deduction for interest and at the same time they don't have any benefit from depreciation, so they really are out of the tax system for those purposes, at least temporarily.

Mr. **Guarini**. No matter which way you go, they are not healthy. Well, thank you very much. Mr. Rohatyn, do you agree with the opinions——

Mr. **Rohatyn**. I think that Marty's proposal is a very interesting proposal. I think it is worth looking at. I think it should be looked at carefully with respect to this question of is it revenue-neutral, but I think it has a lot of merit.

Mr. **Guarini**. I think the time has come, thank you.

Chairman **Rostenkowski**. Mr. Matsui.

Mr. **Matsui**. Thank you, Mr. Chairman.

Mr. Rohatyn, you indicated that you thought that the approach taken by Mr. Brady was a reasonable approach in terms of the deductibility of interest and dividends. Am I correct that you would allow for the deductibility of dividends and at the same time disallow a proportional share of the interest deduction to make up for the lost revenues?

Mr. **Rohatyn**. I don't think I would make that flat recommendation without really looking at the impact of such a move. I think that disallowance of interest, unless it is done in rather limited amounts for securities like junk bonds, where I believe that, in reality, part of the interest is a return on capital and not a true interest, that if you do this across the board you are going to—you may damage a great deal of economic structures.

What I said is to the extent that you conclude that you can do it safely, I would be inclined to use whatever money is raised to begin financing some of the deductibility of dividends, but that I would be more inclined to use a tax on short-swing profits to finance that dividend deductibility than before plunging into interest deductibility.

Mr. **Matsui**. You are concerned about the interest deductibility as two-fold: the increase in cost to capital and then how you define what you are allowed to deduct and not allowed to deduct?

Mr. **Rohatyn**. Yes, just to underline the fact that the cheapest capital in the world is a common stock selling at a high multiple. There is no capital as cheap as equity capital of a high-priced stock and if you look at the Japanese stock market where you see stocks selling at 50, 60, 70 times earnings.

I am not saying that these are conservative multiples, but if you sell stock, you raise money at one or one and a half percent in a hard currency, whereas here if you borrow money at 16 or 17 percent in a currency that isn't quite that hard. You can begin to see the competitive impact of simply the financial power that is created by these two different types of financing.

Mr. **Matsui**. One observation. I think that the only area that this committee could make substantive changes will be in the area of dividend deduction. The problem with that, of course, is an issue of revenue loss and its impact on the Federal deficit. I think all three of you indicated that the interest deduction issue is a very dangerous issue to be playing with.

And I agree with reasons that all three of you stated, the cost of capital and a number of other concerns you raised. I don't know where we go as a result of all of that.

Mr. Rohatyn. I don't know how much money you would raise, for instance, if you increased capital gains taxes on short-swing profits, say profits of less than a year and took that tax, I don't know, to 35, 40 or 50 percent and applied that revenue to a reduction and some element of deductibility of dividends.

My guess is, again, I don't know how much revenue you would raise, but I would think that it would be a good use of revenue to have that trade-off because I am fully alive to the issue of the budget deficit. When ~~you are~~ talking about the kinds of things you are talking about on savings and loans, and you are not capable of dealing with the problem straight up because of the deficit.

We have some serious problems here.

Mr. Feldstein. I think there is a problem with very high rate of tax on short-term gains in that it would cause a postponement of realization. And what do you do about short-term losses? If you allow them to net and offset one against the other, then probably it will have no effect and if you allow them actually to take net short-term losses at this higher tax rate, you can find yourself with a money loser.

And I think that that was the experience that we had when we had the 6-month holding period. Most taxable taxpayers found themselves with losses rather than gains on their short-term trading.

I think if there is going to be a disallowance of part of interest deductions, you ought to offset that with a change to avoid an increase in the cost of capital. You do have two choices: One is to change the tax treatment of dividends and allow a credit for that. That further reinforces the neutrality between debt and equity, but it does nothing for this neutrality between plant and equipment investment and inventory investment on the one hand and intangible investment on the other.

I think that the advantage of using whatever you get from full or partial disallowance of interest to improve the incentives for plants and equipment investment, make that the more attractive way to go.

If you only do it partially, then the modified form of what I said would be disallow whatever it might be, 10 or 20 percent of interest deductions and use that revenue to accelerate depreciation for plant and equipment and to do something for inventories.

Mr. Matsui. I want to thank all three of you. Thank you.

Chairman Rostenkowski. Mrs. Johnson.

Mrs. Johnson. Thank you, Mr. Chairman.

This has been a very good panel and while some of us are in and out due to schedule conflicts it has been good testimony to read. Mr. Rohatyn, have any of the LBO's that you have participated in experienced financial difficulties since their completion and are there any generic causes of those difficulties?

Can you see any pattern?

Mr. Rohatyn. Well, the LBO's that we participated in, in terms of advising boards of companies that were being acquired, have not encountered any difficulties so far. Now we have been retained as financial advisers in one or two cases of LBO's that are in serious difficulties, because of other optimistic assumptions made at the time of the companies going private and of revenue and earnings forecasts that just were way off the mark.

Mrs. **Johnson**. And do foreign taxpayers play much of a role?

Mr. **Rohatyn**. No.

Mrs. **Johnson**. Foreign investors?

Mr. **Rohatyn**. No, I think there are probably some and foreign banks—well, let me amend that.

Foreign banks are very active participants in LBO's at the senior credit level. I don't believe foreign banks are terribly active, direct investors in LBO pools, but I don't know that. But the foreign banks are extremely active in the financing of LBO's especially at the senior level.

Mrs. **Johnson**. I find your discussion of possible solutions very helpful and useful and thank you for it.

Chairman **Rostenkowski**. Mr. Dorgan.

Mr. **Dorgan**. Thank you, Mr. Chairman.

Mr. Rohatyn, let me ask you an unusual question. I just finished reading a book which I thought to be a fascinating account of what has been happening on Wall Street. I wonder if you read it. It is called "The Predator's Ball."

Mr. **Rohatyn**. Yes, I have read it.

Mr. **Dorgan**. I found it to be, as I said, a fascinating book, well-written, very interesting and on point. It deals with Drexel and Milliken and a whole host of others and in fact you are mentioned a number of times in the book.

Is this book a gross distortion of what is going on? Or is it, in your judgment, a reasonably accurate picture of what you know to be happening in these markets?

Can you give me your assessment of that book since you have read it?

Mr. **Rohatyn**. I think it is the first time I have testified in a congressional hearing where I was asked to review a book, so it is an unusual question. On the other hand, I am as competent to do that as I am to make economic forecasts, which is not very, very much.

I think, I mean, let me—this is kind of a delicate question, obviously. I have been very vocal in my opposition of the excessive use of junk bonds in the takeover field and in some of the excesses that have occurred as a result.

I think those excesses are real. I think they are now the subject of legal actions. I think they have hurt the financial community very badly and not only one firm, I think they have hurt the financial community in general. I think they have hurt this country. I think that I would limit my answer to your question to that statement.

Mr. **Dorgan**. I understand. And I understand it was an unusual question. I appreciate your answer.

Having come across this book and read it, I was curious whether this represents——

Mr. **Rohatyn**. Let me tell you something that is a reality in my world. I joined my firm in 1949, 40 years ago. I became a partner 30 years ago. Up until about 7 or 8 years ago when somebody sat down on an airplane next to me and said, "What do you do?"

I said, "I am an investment banker." It was either the end of the conversation in a kind of a polite, bored way, or it was neutral. Now people look at me and either say, "God, I am sorry to hear that." Or, they think I am some kind of criminal.

I think what has happened here is it has made the financial community into a dirty word. And that is what, when I was indicating earlier as being, very, very troublesome, because 90 percent or 95 or 98 percent of the people in my business work very hard and perform a service.

There have been excesses and distortions in the industry and those distortions are not necessarily productive for this country and don't allocate resources necessarily in the best possible way.

Mr. DORGAN. Thank you very much for that testimony.

Secretary of Treasury Brady was here this morning and he made a point I disagreed with. And I would like to know your evaluation of the point. His point was if we evened out the debt-equity problem that we would largely see the disappearance of LBO's.

My contention is that that is not the case at all; that junk bonds represent the propellant that allows me to—people to scavenge for undervalued assets and that those activities will continue unabated with or without our action on evening out debtor equity.

Mr. ROHATYN. I would say that you could reduce 80 percent of the problem by changing the behavior of financial institutions by regulatory means without going to the tax issue. I do think that the tax incentives and—is an important issue, but the behavior of financial institutions, I think, is the major factor in this business.

Mr. DORGAN. The testimony from all three of you was excellent. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Moody.

Mr. MOODY. Professor Friedman, did you give your comments on Dr. Feldstein's approach? Do you have a comment on his proposal?

Mr. FRIEDMAN. Yes, sir, I did. I think it is a useful suggestion, among others, that address two basic objectives. The first, with particular respect to the focus of today's hearing, is to eliminate the incentive for corporate reorganization activity that occurs not from an economic perspective, but merely as a result of the tax distortion.

And the second—which, frankly, I think is an even more pressing concern for the national interest—is to encourage business to undertake more investment in productive plant and equipment and machinery and research. That would reverse the unfortunate drop in investment activity that has occurred in the 1980's, and perhaps restore some vitality to the American economy.

Mr. MOODY. We can now expense a lot of the intangible investments. Is that the point?

Mr. FRIEDMAN. Yes, sir, and also to take the place of the investment tax credit and the liberalized depreciation, much of which was done away with in the 1986 legislation.

Mr. MOODY. And all of you, I guess, think it should be done in a deficit neutral way, depending on the analysis?

Mr. FRIEDMAN. Yes, sir.

Mr. MOODY. Using the Harberger incidence theory, if you alter the tax laws to make debt investment less attractive, are we going to see the requirement that interest rates, pretax interest rates, rise to offset it, because you have a clear substitute ability?

It has to be equalized after a period of adjustment and they will be, so you have to raise pretax interest rates perhaps to adjust.

Dr. Feldstein, do you have a comment on that?

Mr. **Feldstein**. You are also going, though, to be increasing the demand for investable funds by allowing the full deduction of investment in plant and equipment and inventory. That raises the amount of interest that a firm can afford to pay on an incremental piece of capital. But there will be some shifting in the relative returns to debt and equity to the extent that you reduce corporate demand for debt capital and encourage them to shift in the direction of equity.

The other thing to bear in mind——

Mr. **Moody**. It may not disagree?

Mr. **Feldstein**. No.

The other thing to bear in mind is corporate debt is a small part of the total debt in our system. With the Government owing $2 trillion plus and all the mortgage debt, individual owner occupied home mortgage debt, and State and local debt, we are really talking about shifting the demand for a component of the total package of all debt and security.

Mr. **Moody**. Let me ask the three of you, do you think the large increase in debt, public sector, private sector, corporate sector and household sector has increased substantially the fragility of the economy to face an inevitable downturn, or do you think it is overstated?

Mr. **Feldstein**. It is clear that it has moved in that direction. My sense is that some of the worried cries that I hear go too far. One worried cry is right here.

Mr. **Friedman**. I have already had my say on that. I believe the part that is of particular concern is the corporate debt level. The reason why I am less concerned about household debt is that households, at the same time that they have borrowed in record volume, have also taken on record volumes of assets on the other side of their balance sheets. Those assets are not just stock market assets, the prices of which can drop sharply, but also deposits, credit market instruments, short-term government securities, and a whole broad cross-section of assets.

What makes the corporate sector so different is that it is engaged in record volumes of borrowing not for the purpose of taking on assets, but simply for the purpose of paying down equity.

Mr. **Moody**. It has often been charged diverting this much credit to finance takeovers takes credit out of the market. The counterargument is that this money is put back somewhere else and is available again, and that flow of savings is not diminished. How much friction is there? Do any of you have a sense of that? Is it minimal or significant?

Mr. **Rohatyn**. Mr. Moody, I would make a different point. When you take a $20 billion company that has got $4 billion of debt and $10 billion of equity and all of a sudden, you turn it into a company that has $2 billion if equity and $18 billion of debt, you have fundamentally changed the structure not only of that particular company but of a number of financial institutions that are now dependent on this company's being able to service $18 billion of debt instead of $4.

When you were talking earlier about the fragility of the system, the fragility of the system is created by a larger number of financial institutions being dependent on a continued benign economic climate, at the mercy not only of a recession, but a high interest rate environment, which is different.

Mr. MOODY. It may be an inflationary spiral.

Mr. ROHATYN. If there is a recession worldwide, you are going to have problems in the banking system. When you pile debt on debt, you are creating a fragile kind of a structure.

Mr. FELDSTEIN. One point I made in my prepared testimony is a lot of this corporate debt is structured so it is not one homogenous glob of debt for the corporation, the subordinated debt is there in a way so that if the companies run into difficulty of meeting their interest payments, the subordinated debt holders have a strong incentive to cooperate with the management, to keep it a going concern. If they, the last slice or last slices of the debt——

Mr. MOODY. They are almost equity?

Mr. FELDSTEIN. Yes. They have all the incentives of equity at that point.

Mr. ROHATYN. They can bankrupt the company.

Mr. FELDSTEIN. Then the subordinated bond holders will walk away with nothing.

Mr. ROHATYN. A company should not have to live under an operating mode where it keeps looking over its shoulder every day as to whether it is going into bankruptcy or not.

Mr. MOODY. How about diverting management's resources?

Mr. ROHATYN. I think we have reached the point, in a few anyway, we have reached a new economic environment where straight equity is safer than some type of debt. That goes to what Professor Friedman is talking about. Maybe it is time a lot of financial institutions should be encouraged to buy equity. I would rather own a high grade equity than a junk bond in terms of safety both of myself and of the business.

Mr. MOODY. Thank you.

Chairman ROSTENKOWSKI. Let me say, gentlemen, that we certainly appreciate your participation. I know that the committee has a great deal of respect for the opinions that you have, and I hope that we can feel free at some time in the future to call on you to help us participate, if necessary, in writing legislation, so that we can get your expert advice.

Thank you very much.

Mr. Kelly.

Welcome to the committee, Mr. Kelly. Mr. Kelly is a partner in D.P. Kelly & Associates in Oak Brook, IL, and has been a participant in some of the organizational matters that have taken place very successfully, as I understand it. In several conversations with him, he has pointed out to me how streamlining companies is necessary for us to continue to be competitive.

Having said all that, Don, thank you very much for joining us and for being so patient. I hope that you will be able to catch your airplane back to the city of Chicago. But welcome to Washington, and welcome to the Ways and Means Committee.

STATEMENT OF DONALD P. KELLY, CHIEF EXECUTIVE, D.P. KELLY & ASSOCIATES, L.P., OAK BROOK, IL

Mr. Kelly. Thank you, Mr. Chairman.

This panel will not be as distinguished as the prior panel. I assume it will be proper for me to give you some of my background. Currently I am the chief executive of D.P. Kelly & Associates, a partnership formed 3 months ago to buy and manage companies in diverse industries.

From April 1983 through September of 1988, I served as chairman and CEO of BCI Holdings/Beatrice Cos. From 1977 through 1984, I was chairman and CEO of Esmark, Inc., a holding company formed by Swift & Co. I had been employed at Swift since 1953. I was also a senior officer and a member of the board of directors of Swift from 1967 forward.

In addition, I have been privileged to serve on the boards of directors of numerous public companies such as Inland Steel Company, G.D. Serle Co., General Dynamics, Harris Bank & Trust, Trans-Ocean Oil, and McGraw Edison, as well as on the boards of universities, hospitals, museums and other institutions.

During my 40 plus years in business I have managed both large private and public companies. I have participated in LBO's as the CEO of the public company that used the LBO approach to buy other companies and am the former CEO of what was, until recently, the largest non-oil LBO to date.

It has been my good fortune to be a part of what some have referred to as the restructuring of corporate America. I appreciate the opportunity to share my experiences and views as to what has been and is going on in corporate America today.

I am not an economist nor an academic and cannot speak learnedly about the broad subjects of international finance, or the macro impact of financial transactions over long periods of time.

I am a businessman who has been there as a manager, a buyer, a seller, a restructurer, a borrower, a lender. I have faced the tough decisions involved in all those activities. I have participated in opening and closing plants, in increasing and shrinking employment, and in determining how best to use that finite resource, corporate capital.

Based on these experiences, I believe that major changes in legislation, regulation or taxation are not warranted at this time and, in fact, could be extremely detrimental. A few large, highly visible leverage buyouts are calling for changes even though the effects of activities are not widely known. Hopefully these hearings will give us a broader perspective. Once the facts are known and understood it will become clear, I believe, that to curb LBO activities is misguided for the following reasons:

The ability of shareholders to sell their shares and their companies in a relatively free market is an essential capital generation tool and control element in our economic system, despite poison pills, staggered boards, state anti-takeover laws, and other devices.

If we are to remain competitive, ongoing owners or buyers must be free to use any capital structures—including highly leveraged ones—that are appropriate for their circumstances.

I have seen no convincing evidence indicating that mergers, acquisitions, takeovers, recapitalizations, or LBOs reduced overall tax revenues.

Assets sold as a result of an LBO do not cease to be viable businesses. On the contrary, they often perform more productively under new ownership.

LBO's, from my personal experience, do not reduce employment, investment in capital assets, R&D, or a company's ability to compete. The operations of Beatrice are today more valuable, better managed, and faster growing than they were as a public company. They have invested over $280 million in new capital programs and have increased R&D 18 percent. Every major brand they have responsibility for enjoys equal or improved market share and employment is virtually unchanged. Moreover, LBO's do not accelerate unwarranted plant closings or withdrawal from participation in community efforts. And this is true whether they are LBO's instituted by corporate or financial buyers.

Using tax laws or tax regulations as a means to alter the economic environment by restricting the ability of corporations, institutions, partnerships or individuals to engage in transactions is inappropriate. Taxing for purposes other than to provide significant revenue enhancement is, in my opinion, an imposition of control by one sector of the total governing process without recognizing the role and responsibility of the totality.

I elaborate on these points:

Using detailed examples from Esmark and Beatrice in my written testimony. This is not the time for over-reaction to what is a complicated and difficult portion of our economic scene. Those opposed have not yet established any reason for curtailment other than their own negative reactions to what has been a major change in the philosophy of corporate finance.

Today many people view leverage as an important part of an overall financing package. Others feel uncomfortable with this approach because it is foreign to them. This doesn't make them wrong. Until those who oppose the use of debt to enhance our economy make a more convincing case I believe we should be cautious about anything that significantly alters the status quo.

Thank you.

[The prepared statement of Mr. Kelly follows:]

TESTIMONY OF DONALD P. KELLY

My name is Don Kelly. Currently I serve as the chief executive of D. P. Kelly & Associates, L.P., a partnership formed some three months ago to buy and manage companies in diverse industries. From April 1986 through September of 1988, I served as chairman and CEO of BCI Holdings/Beatrice Companies. From 1977 through 1984, I was Chairman and CEO of Esmark, Inc., a holding company formed by Swift & Company. I had been employed at Swift since 1953. I was also a senior officer and a member of the Board of Directors of Swift from 1967 forward.

In addition, I have been privileged to serve on the boards of directors of numerous public companies such as Inland Steel Company, G.D. Searle Co., General Dynamics, Harris Bank & Trust, TransOcean Oil, and McGraw Edison, as well as on the boards of universities, hospitals, museums and other institutions.

During my forty-plus years in business I have managed both large public companies and large private companies. I have also participated in LBO's as the CEO of a public company that used the LBO approach to buy other companies and as the former CEO of what was, until recently, the largest non-oil LBO to date.

It has been my good fortune to be a part of what some have referred to as the restructuring of corporate America. I appreciate the opportunity to share my experiences and views as they relate to what has been and is going on in corporate America today.

I am not an economist nor an academic and cannot speak learnedly about the broad subjects of international finance, or the macro impact of financial transactions over long periods of time.

I am a business man who has been there as a manager, a buyer, a seller, a restructurer, a borrower, a lender. I have faced the tough decisions involved in all those activities. I have participated in opening and closing plants, in increasing and shrinking employment, and in determining how best to use that finite resource, corporate capital.

Based on these experiences, I believe that major changes in legislation, regulation or taxation are not warranted at this time and, in fact, could be extremely detrimental.

My belief is based on the following general conclusions:

1. The ability of shareholders to sell their shares and their companies in a relatively free market is an essential capital generation tool and control element in our economic system, despite "poison pills," "staggered boards", state anti-takeover laws, and other devices.

2. If we are to remain competitive, ongoing owners or buyers must be free to use any capital structures -- including highly leveraged ones -- that are appropriate for their circumstances.

3. I have seen no convincing evidence indicating that mergers, acquisitions, takeovers, recapitalizations, or LBO's reduce overall tax revenues.

4. Assets sold as a result of an LBO do not cease to be viable businesses. On the contrary, they begin to perform more productively under new ownership.

5. LBO,s from my personal experience, do not reduce employment, investment in capital assets, R&D, or a company's ability to compete. They do not, again from my experience, accelerate unwarranted plant closings or

withdrawal from participation in community efforts. And this is true whether they are LBO's instituted by corporate or financial buyers.

6. Using tax laws or tax regulations as a means to alter the economic environment by restricting the ability of corporations, institutions, partnerships or individuals to engage in transactions is inappropriate. Taxing for purposes other than to provide significant revenue enhancement is, in my opinion, an imposition of control by one sector of the total governing process without recognizing the role and responsibility of the totality.

I would like to elaborate on each of these points.

First, the importance of free securities markets for capital generation and control.

Companies look to the stock market as an important source of capital. If the stock market is not reflecting values that are reasonable, then the use of new equity as a source of growth or support financing becomes very unattractive since any new issue would represent a dilution to current shareholders.

In my opinion, the current stock market has been generating and supporting higher than historic values because buyers of companies have been willing to pay more realistic values for control positions. Altering traditional tax or other considerations will restrict buyers, significantly reduce the value ascribed to equities, and have an overall deleterious impact on corporate growth. Capital, under this scenario, becomes too dear for the benefits to be derived from investments.

The other implications of a less than healthy and viable stock market are too numerous to cover in these remarks. Suffice it to say that anything that casts a pall on the stock market would represent, in my opinion, a serious blow to our economic well-being.

From a control standpoint, many corporate managers see their position as some sort of a "God given right" and will go to great lengths to protect their positions even though their current business conduct and performance are less than commendable. In the mid-sixties, Swift & Company, after years of being one of America's largest companies, was being managed with little concern for its deteriorating performance and lack of future potential. Swift was not unusual then. A complacent, self-satisfied approach was one of the reasons U.S. business, after the benefits of post-war demand and inflation waned, found itself a high-cost producer having great difficulty competing in world markets.

In the case of Swift & Company, market forces and the unconstrained ability of others to buy the company combined to inspire management, or more properly stated, forced management to drastically change a slowly retrogressing and possibly dying corporation. A series of threatened takeovers caused a new management team to critically assess Swift and to do what should have been accomplished years before. A major realignment was undertaken in 1968, resulting in a complete corporate reorganization and a new program of diversification. Over 300 units were closed, activities were sold, centralized management was replaced by decentralized management, and every operation was assigned a responsibility for growth and profit.

As a direct participant in this reorganization, I can attest that had the company been shielded from potential buyers, the changes would not have been made or at best the pace and breadth of the programs would have been minuscule. I assume today, if this had been an LBO, the critics would have a field day and the fact these moves were essential for survival would be lost in the rhetoric.

In 1973, Swift, having survived and emerged as a viable growing conglomerate, formed Esmark with market capitalization of $300 million. In 1980, Esmark's management, seeing a stock market placing a value on corporate assets below what they believed was reasonable, once again restructured. By reducing the company to half its size, taking a portion of the company public as a new entity, and selling off major asset groupings, shareholders' values increased over 200 percent. A new, smaller Esmark emerged in what was the first major corporate restructuring aimed at providing shareholders with values that can only come through some form of ownership change allowing shareholders to realize market premiums.

The Swift/Esmark saga is a perfect example of a change in control, or threat of change, that increased shareholders' values and allowed new growth and employment in businesses whose survival was questionable.

My second point is the danger of placing restrictions on capital structures.

There is no such thing as a perfect capital structure with a ratio of debt to equity that is responsive to all businesses and their individual needs. Both debt and equity have had an important role in funding businesses and both have had traditional tax treatment. Business, as a general rule, has moved from thinking that debt is an inappropriate source of capital to a recognition that creative financing is an essential ingredient for success.

There is a great deal of misconception about the role debt plays in an LBO. Debt is a large portion of the original transaction but it is, in fact, interim financing. In the Beatrice purchase, KKR borrowed some $3.5 billion in bank debt, $2.5 billion in high yield securities, and assumed $1.1 billion in long term debt that Beatrice then owed. Some 32 months later, all bank debt has been repaid. All of the high yield securities have been retired, and the old Beatrice debt is down to less than $850 million. Debt was utilized as a major funding source along with equity but still retained its role as an interim vehicle. KKR and Beatrice management addressed the need to manage that liability in a timely and appropriate fashion.

Corporations also use leverage when they purchase companies, a fact that is frequently overlooked in talking about LBO's. Esmark borrowed some $1 billion to buy Norton Simon in a corporate LBO. The debt was repaid in nine months through the sale of assets, issuance of stock, and cash flow generated by Norton Simon. This is a pattern not at all dissimilar to what happens in a so-called financial LBO.

One of the frequent warnings about debt and the use of high yield bonds as financial tools is this statement: "If interest rates go up, LBO's will be in real trouble." An analysis of capital structures shows bank debt, the variable rate portion of LBO financing, is most senior and paid first. Most LBO's begin reducing that portion of their financing early on and the fixed rate component of "junk" is longer term. Significant increases in current interest rates enhance the value of bonds having fixed rates. Furthermore, interest costs are a portion of all business liabilities and increased rates are generally reflected as a portion of a business's recoverable costs over time.

Imposing new taxes on, or changing the traditional tax deductions available to those using debt will force a change in the capital structure of U.S. business, further increasing the financial advantage of overseas competitors. Foreign businesses have traditionally used debt to a greater extent than American companies.

This is not the time to make changes that create new hurdles or impose new restrictions on financing sources. Flexibility for corporations, partnerships or individuals to finance in the most efficient manner is essential for business growth and prosperity. Any changes that reduce that flexibility can be extremely detrimental.

Third is the question of tax revenue lost due to LBO's.

There is no study, documentation or evidence I have seen demonstrating that LBO's cause an overall tax revenue loss as a result of interest deductions offsetting previously taxable earnings.

On the contrary, a corporation's deduction for interest expense is offset by another entity's interest income. LBO's create significant capital gains on the part of shareholders since their shares are purchased at prices far in excess of current or reasonably anticipated future market values. This is certainly a capital gains windfall for the Government. Moreover, the stock market is influenced by the presence of LBO buyers. This has the effect of creating overall higher stock prices and therefore higher taxes on any sales of securities.

In addition, fees paid for debt, investment banking efforts, and related LBO expenses are generally taxable currently to recipients but must be amortized over time or are not deductible to the LBO company, thus creating added or early receipt type revenues.

Finally, an LBO buyer purchases a group of assets carrying an historic tax basis. A whole new series of tax revenues is created if some of these assets are subsequently "marked to market" and sold for a price above the value taxed in the original transaction.

There are, therefore, a number of new or accelerated tax revenues available to offset reductions in taxes resulting from LBO's. There is no reason for precipitous action in this area.

The next issue I'd like to discuss is the sale of assets.

One of the concerns voiced about LBO's is that companies or assets are sold to pay down debt. This is somehow viewed as being an activity that contributes to a decline in the overall health of business. The strange thing about this is the observations or criticisms often come from those who have evidenced concern about companies being too large with a so-called concentration of power or too complex to manage due to the diversity of their activities.

In 1980, Esmark received great kudos for reorganizing, selling off assets, and shrinking its activities by some fifty percent to provide shareholders with high returns. This "growing by shrinking" was adopted by many companies as they have gone through what is now called a "recap" or recapitalization. Many of these have been undertaken as defensive moves to avoid changes in ownership by providing shareholders with current recognition of values.

Companies or operations that are sold do not go off to some far planet. They become part of other entities or independent operations and remain as market participants often with new vitality and opportunity. The sale of assets by Beatrice, involving some $6.8 million, directly contributed to two new public companies, one ESOP, four new private companies, and a number of additions to the existing operations of public and privately held companies. Overall these activities today have greater market share, employ more people, and are generally viable and growing participants in the economies in which they operate.

Reshaping of companies by buying, selling, reorganizing, or altering assets should be an ongoing activity in any company. My experience at Swift, Esmark and Beatrice demonstrates to me the exercise makes sense regardless of the corporate form of ownership.

This brings me to the impact of LBO's on employment, R&D, capital spending, and plant closings.

There is a popular belief that LBO's, due to the leverage involved, create a situation where management must reduce all but the most essential expenditures. According to this misconception, LBO's are by definition bad for the economy and for the future well-being of America's business.

But consider this: The remaining Beatrice operations are today more valuable, better managed, and faster growing than they were when KKR's investors bought them. They have invested some $280 million in new capital programs, have increased R&D some 18%, every major brand they have responsibility for enjoys equal or improved market share. Employment levels have been maintained.

Purchasing a company and then withdrawing the financial support necessary to maintain and grow the value of what you have paid a premium to buy makes no economic sense. A strategy to enhance long-term value cannot be served by failing to provide the funds necessary for viable operations and growth.

Plant closings are often used as an example of problems created by LBO's. But it is counterproductive for a buyer to reduce productive capacity and thus the opportunity for market participation. In most cases, the cash costs of closings, separation pay, loss during shutdown, maintenance costs of a closed facility, etc., represent a significant short term penalty supportable only if the closing protects or provides significant future earnings.

In fact, plant closings after a leveraged buyout are no more wrong nor right than closings undertaken at any time by public companies such as General Motors or by Chrysler. After the LBO of Beatrice, we closed a total of three plants. Operations from two of them were combined in an enlarged existing facility and one was replaced by a new plant.

In any change of ownership, there is or should be a reassessment of all activities. If there are inefficiencies, redundancies or lack of purpose in any activity, a reshaping takes place. In many instances, this calls for reducing personnel, usually at the staff level. In Beatrice, we found excessive headquarters staff, unaffordable activities that were not justified on a cost/benefit basis, and an unwarranted degree of centralization. It is important to note that while staff reductions were made at the headquarters level, overall employment in those operations that remain a part of Beatrice has been maintained.

R&D investment by a company that has been through an LBO should be weighed using the same evaluation process undertaken at public companies. If there is a lack of focus or indeterminable corporate benefit, R&D budgets should be reduced. At Beatrice, we reduced some activities but increased others. As a result, the total R&D budget for the current year exceeds the budget for the year prior to the LBO by 18 percent. However, that in no way proves reduction in R&D budgets cannot be justified in many situations.

Capital spending is an area that seldom lends itself to year-to-year comparisons. A reduction or an increase can be significantly influenced by one major expenditure. At Beatrice, however, businesses that were retained were provided on a broad basis with more dollars in the first year of the LBO and each budget since than in any pre-LBO year. As CEO I was never refused the funding for a major capital request by the board representing the LBO shareholders.

Again, drawing on my experience, both publicly-held and LBO-owned corporations support businesses with capital when management and ownership understand the basic principles of business management. If they do not, there is no limit to the number of poor decisions that can be made and they are not all in the capital allocation area.

Companies or operations purchased in LBO's are not automatically less concerned corporate citizens. Most continue to participate as active contributors of time and dollars to worthy community efforts and activities. At Beatrice, the size of The Beatrice Foundation was increased and its activities broadened. Corporate and individual participation in the United Way campaign today is at an all time high and many employees have continued or increased their personal participation in other community efforts.

In many instances, management's increased ownership position in a company through an LBO creates an atmosphere conducive to an in-depth analysis of all expenditures, thus reducing unwarranted or inappropriate ones. This should not be a condemnation of LBO's, but rather a sign of effective business management in any organization. It is, in fact, one of the reasons LBO investors and their lenders do well.

My last point concerns using the tax laws to inhibit financial transactions.

It would be, in my opinion, wrong to change the tax laws for the purpose of eliminating the use of leverage in financial transactions, especially since there is no convincing evidence that by doing so there would be tax revenue enhancement. In fact, there are reasons to believe that eliminating or restricting tax deductions for debt will have both long and short term negative tax revenue implications.

Eliminating tax deductions for the debt component of a purchase price will make the cost of purchase significantly higher, and have, in my opinion, two consequences. First, market values will fall until it is affordable to buy without deductions. Second, takeover activity will stop, at least for some time, as the tax code becomes, in effect, a market control device. Both of these would be a step backward and could have a very detrimental effect on business in general. We should not ignore the experience of October 19, 1987, where concern about restrictions on corporate purchases was a contributing factor to the wrenching readjustment of market values.

Any restrictions placed on deductibility of interest have implications far beyond LBO's. Companies borrow money for any number of reasons. Should they, in effect, be penalized when they borrow for internal growth or expansion, or borrow to support working capital for growth, or borrow for interim financing that might be required in a seasonal business? And if the answer is no, how can debt in a large company be segmented to identify the portion used for acquisitions and the portion used for internal growth?

Sale of a company has been the ultimate reward for the entrepreneur who builds a business and then reaps the benefits of his effort by selling to other entities or buyers. Restricting sources of capital available for purchase by changing the tax laws would be a fundamental change in our economic system. It would be regrettable for such a change to be instituted in reaction to a few large, highly visible LBO's that, due to their size and complexity, are misunderstood by many.

In conclusion, this is not the time for knee-jerk reactions to what is a complicated and difficult portion of our total economic scene. Those who oppose the use of leverage or the level of company debt have not yet established any reason for curtailment other than their own negative reactions to what has been a major change in the philosophy of corporate finance.

Today many business people view leverage as an important part of an overall financing package. Others feel uncomfortable with this approach because it is foreign to them. That doesn't make the use of higher leverage wrong. Until those who oppose the use of debt to enhance our economy make a more convincing case, I firmly believe we should be cautious about doing anything that significantly alters the "status quo".

Thank you.

Chairman **Rostenkowski**. Thank you.

Don, I certainly appreciate your appearing before us today. The reason you are down there at the witness table alone, Mr. Kelly, is that many of your colleagues are unwilling to join you.

Mr. **Kelly**. I hoped it was nothing personal.

Chairman **Rostenkowski**. No sir, it was not.

We read in the press commentaries that one of the big factors driving these deals is the large fees of investment bankers. Do you agree, and if so, what suggestions, if you would like to offer them, would you have to reduce this factor in those deals?

Mr. **Kelly**. Well, I suppose that the person who sat in this chair prior to me, Mr. Rohatyn, would be better equipped to defend the fees they charge. I personally have always thought the fees were too high, even before they got to today's level. However, we are in a competitive market and they are providing a service and so long as they provide that service they can charge what they get under our system. I think it is proper that we allow other folks to enter the business and make it more competitive, but until that time, I really don't feel that it would be proper for me to determine whether or not their fees are in keeping with their contributions in deals.

In those transactions I have been in, we have, I believe, exercised a great degree of caution as to how much money we will pay them. I will have to leave it at that, Mr. Chairman.

Chairman **Rostenkowski**. Do you have, with respect to your contracting, anything to say about the fees? Are the fees just scheduled or is there a percentage of the deal?

Mr. **Kelly**. Well, you have a negotiating position you can take. If they come in and say they want 2 percent of the deal, you can say that is unaffordable and I will not afford you the opportunity to charge me that much. We are not usually that nice to each other, but it is in that general tone.

We are faced in business today with tremendous costs as it relates to legal, accounting, and investment banking fees. We have to absorb them. Unfortunately our consumers are the recipients of a portion of them. But there is really nothing I think we should do legislatively to change that situation. I think competition will have to make that determination.

Chairman **Rostenkowski**. You have been sitting here for a little while, Mr. Kelly. I think that you would recognize that the committee is conscious of how sensitive this area is and how we as a committee can change pretty much the effect of what a deal will be. We are also sensitive about what we should or what we should not do. I think that the purpose of this meeting with you and the industry and the committee is to get a better understanding of what is happening. I want you to know that I personally appreciate the fact that you have joined us today and given us your opinion. I know that you are a great believer in the free marketplace and as little government as possible. I appreciate the fact that you have——

Mr. **Kelly**. I don't believe in eliminating Congress, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Pickle.

Mr. **Pickle**. Mr. Kelly, it has been a long day, and I don't want to extend these hearings, but let me ask you a couple of questions.

You say in your statement that if we are to remain competitive, ongoing owners or buyers must be free to use any capital structures, including LBO's. You make the strong point that if we are going to be competitive, we must be free. Now, in what way was RJR/Nabisco competitive? Where was competition being helped or hurt in that big takeover?

Mr. **Kelly**. I think it would be improper for me to use RJR as an example. Let me use an example of my own experience. Swift and Company was one of the largest companies in the United States. When people came in that were going to take over the company, the management addressed things that they should have addressed a long time before that and did what should have been done, but wasn't done by the preceding management. We reorganized the company in its entirety.

I suggest to you if it had not been for the pressure of a potential takeover that we would not have reacted to that degree.

Mr. **Pickle**. There certainly are cases of mergers and acquisitions where the process is a good one and helps business. I don't think anybody ought to disagree with that. That is why this question is so difficult to handle.

But there are some cases where you have to ask if the big merger helps competitiveness. It is hard for me to see how the RJR/Nabisco buyout is really going to keep them competitive. You can say they can reorganize as you said Swift did. Maybe that reorganization gives them a chance to trim down their structure and save a little money, but for the most part, in the RJR deal, it seems to me like they are going to sell off a lot of assets just to pay this high debt and somebody is going to make a lot of money.

I question whether we are really keeping them competitive, whether we ought to allow them to take a big, huge profit in legal fees and get 6 percent of $25 billion. That amounts to a lot of money. I just say in every instance this business of keeping them competitive just doesn't fit, in my judgment.

Mr. **Kelly**. Mr. Congressman, being from Texas, you understand that there are big deals and there are little deals. In this particular instance, we are talking about a very large transaction. But just as a mortgage is an LBO, there are lots of them out there for $50 to $100,000. They are no more risky than the ones for $5 million so long as the basic house or structure involved affords the lender the protection that should be there.

Second, we have in RJR an organization that is very, very large and there are some real questions as to whether it was being used to the maximum benefit of its shareholders and the businesses in which they engaged. When we bought Beatrice, we sold off $6.9 billion worth of assets. From that has come three public companies, an ESOP, four private companies, and a number of activities that are parts of ongoing organizations. Across the board, those companies today employ more people, are better companies than they were when we bought Beatrice. I don't think that we can conclude that the RJR transaction is going to do anything other than afford that same opportunity.

Mr. PICKLE. Most of us today have said that using the tax structure is just an incentive for these big mergers and these LBO's to go forward. We ought to try to keep the tax structure from being used. You said in your statement that using the tax law and tax regulations as a means to alter the economic development by restricting usage would be improper. It ought to be improper for the big companies to use the Tax Code for this. If it is true in one instance, it ought to be true in the other.

Mr. KELLY. Congressman, I disagree with you that these things are tax driven. If there is not a basic economic value for engaging in the transaction, regardless of what tax consequences are, we are not going to go ahead with it. There is not enough benefit in having a deduction for interest as opposed to other activities to make it worthwhile doing transactions for tax benefits.

Mr. PICKLE. Mr. Kelly, surely we would agree that we ought not have the Tax Code so set up that it can be an incentive for these big LBO's. It ought to be neutral as best we can determine it.

You list me these six categories, but you didn't say anything about junk bonds. Do you think they are a good development out of all of this?

Mr. KELLY. I don't call them junk bonds because I call them high yield securities. I have been in businesses where we were not investment grade and had to pay more for our money, and nobody was concerned, and they did not call them junk bonds. If you are willing to risk your money you have to have a reward commensurate with at least the risk that you assume.

I don't know what is wrong with junk bonds. Possibly you can, you or someone on the committee can tell me. I have listened to Mr. Rohatyn talking about it. He is against it. I think if I were running his firm, I would be against them, too.

Mr. PICKLE. We are not alone in calling them junk bonds. Industry is calling them junk bonds. They are just high yield investments, whatever you call them. There may not be anything wrong with them today, but 5, 10 years from now it may be a real problem for us. If that were to happen, people are going to say, Mr. Congressman, why didn't you do something about this to protect us?

Mr. KELLY. I have been in business a long time, and I have been waiting for the day when the instruments I use for financial activities are as predicted, going to go bad sometime in the future. The implication is if we have junk bonds we are going to retain them, and not pay them back. My experience at Beatrice, is, we borrowed $3.5 million from the banks and, $2.5 in what you refer to as junk bonds. The corporation we bought had $2 billion in corporate debt. Today there is no bank debt, no high yield security left outstanding. There is $850 million in corporate debt left out.

Now, I don't know whether this terrible millenium is going to come and I don't know that we won't be able to pass on at least some of the cost of one of the commodities that we use in business called money. As I said in my opening statement, I am not an economist and I am not an academician, so I am not afforded the opportunity to change my mind every 3 weeks.

As far as I am concerned, we have not had in my business career, which extends an awfully long time, a period where we who know how to play the business game, if you want to call it that, or how to run businesses, have been faced with situations that do not afford the opportunity to manage our way out of these situations whether they be refinancing, changes, or whatever. I don't think that we are going to suddenly find that all of the junk bonds are going to go sour or go south.

Mr. PICKLE. I appreciate your views. I will pass on what you said here.

Chairman ROSTENKOWSKI. Mr. Dorgan.

Mr. DORGAN. Thank you very much.

Mr. Kelly, although I disagree with some of what you believe, I have great respect for what you have done, and what you have achieved in your business life. While your personal anecdotal evidence is helpful to this committee, my own judgment is that it doesn't define the rule.

There are a number of studies, some of which I have quoted here, that suggest that it is not true that the target companies are the underperformers. In fact, the target companies have been slightly above average performers before the acquisition and the entire corporate unit after acquisition has been a slightly below average performer. Can you respond to those studies? Do you have other studies that demonstrate those are inaccurate?

Mr. KELLY. Congressman, I have to tell you that although I was the opening speaker at two of the conferences covered in "The Predator's Ball," I don't have advantage of studies that tell me that these were high performers or low performers. All I can use is my personal involvement, not only at the company that I have been directly involved with, but the companies that have been purchased subsequent to my participation as a member of the board of directors.

I have seen companies that were performing, not up to the standards that they might perform, improve because a new management or a new approach was taken. It doesn't make a lot of sense to me that I could pay a premium for a company that is already outperforming everyone else, and has market recognition, and then I can turn around and be in a position to do better than they did. It seems to me it would be more advantageous to me if that company were not performing to the levels I might anticipate it making.

Mr. DORGAN. I have got to confess that a lot of what is happening appears to those of us on the outside to deal more with greed than good business sense. I admit some LBO's, mergers and acquisitions, are probably very important and very useful for this country, but a lot of what is going on represents an excess in greed.

Let me use the RJR as a business company example. Let's assume I was on the board of directors and the fellow running my company said I want to buy this place and I am going to offer $75 a share. Ultimately it is sold to somebody else for a substantial increase above that. A shareholder would ask what on Earth is this person running the company doing suggesting that if somebody else owns it, he could do a better job of managing it. I thought I was paying him to manage the assets to the best of his ability. I think I would have fired that person in 5 seconds.

Mr. KELLY. I think it would be an appropriate action, one that should have been taken had the board of directors been as responsible as they should have been.

Mr. DORGAN. That decision was motivated by greed. My impressions of what I read about these deals suggests we have got a lot of folks floating around here using junk bonds as a new instrument.

You talked about your entire business career. My guess is that you would answer in the affirmative that never in your entire career have circumstances created the conditions that exist today for a fellow like Icahn or Perleman, or others, to become players going after targets twice their size. Only the existence of junk bonds in the 1980's and the acceptance of investors to go ahead and use those junk bonds has allowed that to happen.

That didn't happen 15 years ago and didn't happen 25 years ago. Is that a fact?

Mr. KELLY. I think that you are selecting a course of action that happened and say people's creativity is restricted to junk bonds. I do not agree with that. We have created different ways to acquire companies, to change management, going all the way back to the 1960's. They called it funny paper, they called it Chinese paper, and a whole host of other kinds of approaches. Junk bonds are today the focus of attention. But for me to sit here and tell you that that is the only way we would have gotten to where we are today, I think is improper.

Mr. DORGAN. Again, your testimony is useful. I appreciate very much the anecdotal evidence you have presented. Thank you, Mr. Kelly.

Chairman ROSTENKOWSKI. Mr. Crane.

Mr. CRANE. I want to thank Mr. Kelly for his presentation. I am sure you heard Dr. Feldstein's presentation. Dr. Feldstein suggested that one of the concerns is that there is not enough investment under incentives in the code to get businesses to engage in R&D or modernizing plant and equipment or increased productivity. Yet based on your testimony, you suggest that with the restructuring that you have been personally familiar with, those restructurings have maintained at least the same level of productivity or increased it. I am wondering what your assessment of Dr. Feldstein's proposal might be? If, for example, we went to his so-called cash basis business tax, would that be preferable to the existing write-offs that are available to businesses through taking on excessive debt?

Mr. KELLY. I have been a cash flow advocate for a long time. I suggest to you that we had stimulus provided in the tax laws before ITC and accelerated depreciation. I suggest to you that if you go to the cash flow writeoff, and we are sitting here a year or two years from now, you are going to reverse yourself again because you will find you have a revenue shortfall. While I would love to see that kind of situation, I think that the doctor has to provide more in the way of income to offset that loss of tax revenue.

I am probably the foremost proponent in American business of not paying taxes. I have hired people, ever since I have been in the position to do so, to minimize the amount of tax I paid. It had nothing to do with whether or not you were properly compensated. It had to do with whether or not we could get the maximum benefit. I think that I would have some reservations if you came out with a dramatic change announcing that you are going to change rules again.

Mr. CRANE. I think he indicated it would be to have a phased-in change. He suggested it would be revenue neutral.

Mr. KELLY. Everybody talks about a level playing field. On a level playing field, the 49ers will always beat Columbia. I don't know what a level playing field is except that whatever we have today apparently isn't level and that there is some Utopian area of level we are going to reach some day. I hope I am still around for that. I don't know if I will be.

Mr. CRANE. The ultimate Utopia to me would be if we eliminated taxes on business and levied it on businesses up front and eliminated all taxation of passive income. That is the millenium and I know that will never occur.

Thank you, Mr. Kelly.

Chairman ROSTENKOWSKI. Mrs. Johnson.

Mrs. JOHNSON. Thank you very much.

Mr. Kelly, I find your testimony very interesting and appreciate your being here. Your experience with Beatrice is not only instructive but confirms my much more limited experiences. I have watched the breakup of some of the conglomerates in my district as they sold off businesses they never should have gotten into and didn't know how to manage.

Certainly the weakness of American management has been demonstrated by the changes that have taken place in manufacturing management in response to the competitiveness challenge, in hospital management in response to the cost control challenge and so on and so forth. I think there is a lot that you say that we need to listen to very carefully.

There are two things that concern me. One is that junk bonds are not ordinary capitalism. From where I sit, it seems to me that junk bonds don't represent the kind of equity investment that in the past we have always required of purchasers. When I look at, for example, how much of American business has gone under in times of recession, when I look at a recent Brookings Institute study that showed if we had a recession as severe as the 1973 one, we would lose 10 percent of America's businesses, I can't help but believe that a business that has undergone this kind of financial restructuring would be much more vulnerable if we had that kind of situation. So I wonder if it isn't time for Government to say if you are going to buy, you have got to have something to buy with as we used to see as a matter of course. That is one concern that I have.

On the larger issue of Tax Code treatment of equity versus debt instruments, should we be thinking about moving toward a more uniform treatment of those things, and is now the time to do it?

Mr. KELLY. Taking your final point that moving to a more equitable treatment of the two means that those of us who would be involved in buying companies and so forth would be offering equity structures of some sort to the people who would be supporting us. It doesn't entirely eliminate, if that is the purpose of it, the ongoing situation where if you have leverage, be it called equity or be it called debt. Now let me try to explain. If I had deductibility for preferred stock, for example, so instead of issuing debt, I issued preferred stock, if it cost me 15 percent before and whatever the after-tax effect of that might be at that time for both kinds of instruments, I haven't changed the basic compensation significantly. I have subordination which is called equity, but I still have an ongoing need to meet that requirement of paying it, either today or tomorrow on a cumulative basis. I believe that if we change what we are doing today to a situation where we have both debt and equity having the same kind of treatment, that we will use a mix of debt and equity to whatever is advantageous to those as the buyers and hopefully advantageous to those who were the lenders to us. I am just not smart enough to understand all of the ramifications as I listen to these very learned people talking about equity and debt.

During the testimony one of the things pointed out was we have a recent phenomenon called junk bonds, but we have a reduction since 1980 in investment in capital goods and so forth. Therefore, junk bonds are bad. Where is the correlation? We don't have a situation where the only people that don't invest are people that have LBO's or high debt. The people that don't invest are those that do not see the opportunity for return within the cycle of the economy that they are in. I guess that in attempting to answer your question, I have lived with high leverage most of my life, starting in the south side of Chicago where the Kellys were leveraged, and it has never changed that much. I feel comfortable with it because I manage it. I don't leave myself in a posture where if there is a recession I am going to be so exposed that I can't take care of it. I don't borrow myself into a position where if everything doesn't go up, I am suddenly in trouble. I have operated in these kinds of cycles. I have operated when we have had the strong dollar, the weak dollar, high interest rates, low interest rates and all the other things that go on. I think that a prudent manager can use that to his or her advantage so long as they are a prudent manager and a good manager. If it changed—if you change the rules, I am a little old to say this, but if you change the rules, I'll be back and I'll be doing it and I'll be doing it some way.

Mrs. Johnson. Thank you.

Chairman Rostenkowski. Don, thank you very much. Are there any further questions? Thank you very much for joining us this afternoon. I know how busy you are. I hope we don't have to bring you back. But I tell you one thing, if we change the law, you'll figure out a way to work at it.

Mr. Gradison.

STATEMENT OF HON. BILL GRADISON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. Gradison. Thank you, Mr. Chairman. I appreciate this opportunity to testify before the committee to express my thoughts on the general issue before us. Let me begin by saying that I am not going to focus on the narrow issue of leveraged buyouts, or even the larger issue of mergers per se, but rather the general issue of the tax treatment of debt and equity. In 1986 we took great strides toward removing tax considerations from individual and business economic decisions. The 1986 act did not, however, address the biases with respect to taxation of debt and equity in the corporate tax system. I believe that the current concern over LBO's provides us with a new opportunity.

Let me say at the onset that I am not convinced that the corporate takeover binge is tax motivated. Indeed, the evidence seems to indicate they are not. Furthermore, much of the increase in corporate debt as a result of takeovers is transactional; that is, the debt is used to facilitate the acquisition, and the intention is to retire or substantially reduce it as soon as possible.

Morever, much of the current discussion of corporate debt ignores history. Yes, debt to equity ratios have risen dramatically in recent years during the ongoing, unprecedented recovery. However, the level of debt to equity is essentially the same as it was in 1970, following another period of strong growth. Furthermore, when assets are valued at market prices rather than book value, the current debt to equity ratio is significantly below that of the highs of the mid 1970's. In addition, U.S. corporate debt to equity ratios are generally well below those of our trading partners. In all these respects, we should avoid being myopic.

As we all know too well, the current system hits returns on equity twice—once at the corporate level and once at the individual level—while interest payments are taxed once—at the individual level. This establishes the bias in favor of debt which can be removed by equalizing the tax treatment of debt and equity. I believe this can and should be done in a revenue neutral way.

I asked the Joint Committee on Taxation to determine an equal tax deduction for both interest and dividends that would maintain revenue neutrality. Their analysis, which they stress is tentative and preliminary, indicates that an 80 percent deduction for both interest and dividend payments would equalize the treatment of capital without affecting revenues and, hence, the deficit.

This rate could be phased in over a 5 to 10 year period to allow companies to adjust their debt and equity positions. For example, the deduction for interest payments could be reduced to 98 percent in the first year, 96 percent in the second, 94 percent in the third, and so on for 10 years until it reached 80 percent. At the same time the deduction for dividends could increase from 8 percent in the first year to 16 percent in the second and so on as well until it too reached 80 percent in the 10th year.

By equalizing the tax treatment of interest and dividends we would enhance the policy of removing tax considerations from business decisions. Less debt and more equity will not affect the national savings rate, but there is no reason tax policy should favor one over the other.

My proposal would significantly reduce the double taxation of dividends by virtually eliminating the corporate level tax on dividends.

I realize that there are some problems with my proposal. The first is that dividend payments to foreign shareholders and tax exempt institutions would be subject only to a single tax at a maximum rate of 6.8 percent—20 percent of the 34 percent corporate rate. This concern seems minor.

The second problem is that not all corporations would be affected equally. For totally legitimate business reasons, for example, some companies rely on loans for capital and pay little or no dividends. Such a company would lose 20 percent of its deduction for debt payments, which are legitimate costs of doing business, but would gain little or nothing from the 80 percent deduction for dividends paid. Nevertheless, the decision to raise capital through debt rather than through equity would be made on economic considerations and uninfluenced by tax considerations. In my mind, this primary goal of tax reform overrides this concern.

The final problem I see is that the aggregate corporate debt-to-equity ratio in the absence of a tax bias favoring debt cannot accurately be predicted. Neither can it be assumed that the ratio will not, or should not, change over time. If it did change, the allowable deductions would have to change if revenue neutrality is to be preserved.

None of these issues strike me as insurmountable.

In conclusion, Mr. Chairman, I wish to reiterate that the continuing economic expansion should not be threatened by increasing corporate taxes under the guise of controlling merger mania. Nor should we add to the Federal deficit to provide a deduction for dividend payments. We can, however, take the opportunity provided by the current concern over LBO's to reform the tax treatment of returns to capital. By providing an 80 percent deduction for both interest and dividend payments we can level the playing field without increasing the deficit or raising corporate taxes.

I believe this would be a positive step toward reversing the trend for greater corporate reliance and debt and would virtually eliminate the double taxation of dividends, thus dealing with one of the most important and most needed aspects of our committee's business left unfinished in the Tax Reform Act of 1986.

Mr. Chairman, I have in hand the letter from the Chief of Staff of the Joint Taxation Committee dated today which provides the revenue estimates which are the basis for my testimony and will pass it along if it meets with the chairman's approval for inclusion in today's record of the proceeding.

[The information follows:]

[illegible]

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JAN 31 1989

Honorable Willis D. Gradison, Jr.
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Gradison:

This is in response to your request of December 25, 1988, in which you asked for an estimate of the rate at which both corporate dividends and interest could be deducted from taxable income such that there would be no net gain or loss to fiscal year budget receipts.

As you noted in your correspondence, a significant behavioral response would result from implementing this proposal. Although a revenue estimate would take account of this response, we have not attempted to include this effect in these calculations. We have also assumed that the proposal does not contain any provisions to restrict the deduction available for dividends paid to foreigners, tax-exempt organizations and other corporations. Finally, it should be noted that, in order to maintain revenue neutrality, the percentage of partial deductibility for interest and dividends would likely differ in each future year.

Assuming that the proposal were to be effective in 1989, with no grandfathering of existing debt, the preliminary, static calculation of the rate of partial deductibility necessary for revenue neutrality in that year is 80%. Stated alternatively, in 1989 the revenue increase resulting from a 20% disallowance of the deduction for interest paid would be equal to the revenue decrease resulting from an 80% dividend paid deduction.

If we can be of further assistance in this matter, please do not hesitate to contact us.

Sincerely,

Ron

Ronald A. Pearlman

Chairman ROSTENKOWSKI. Mr. Brown will inquire.

Mr. BROWN. The proposal is thoughtful, imaginative, as I think all of us would come to expect any proposal coming from you to be.

Let me ask a couple of questions, though, that seem to me might be potential problems. Is it possible that the fact that interest becomes largely not deductible at the corporate level and continues to be deductible at the personal level, clearly with some exceptions as you are well aware of in our current law, is it possible that all this will accomplish is move the leveraging that takes place at the corporate level back to the personal level?

Mr. GRADISON. What it would do if these joint committee estimates prove to be accurate on further analysis, is to exclude from deductibility only 20 percent of corporate interest payments, 80 percent would remain deductible, and therefore to—your phrase was, would make these corporate interest deductions largely nondeductible.

Actually, my plan would continue to make them largely deductible, 80 percent deductible. That really is, to me, if I made any contribution here, it was to the number. I was surprised that the number was that high. I thought in principle it made sense to equalize these, but I had no idea that there was so much more debt outstanding than equity that the numbers worked out would make it possible to continue to deduct as much as 80 percent.

And then I looked at it and say, let's phase in over 10 years, which is the period of time which was suggested in Treasury I and II, as I recall it, for their more modest proposal, and worked it out in terms of the changes year by year.

I said to myself, well, that is worth sharing with the committee for their consideration, because it is really a drop from 100 percent deductibility, as I said earlier, to 98, the next year, 96 and so forth, very modest changes to 80 percent when in full effect, 80 percent deductibility, 20 percent nondeductibility or exclusion.

Mr. BROWN. I think that is very helpful, I appreciate the clarification. I am wondering, does it give you concern, or do you think the value outweighs the concern that you may be taxing corporations when they, in effect, have no gain or income. Because of the restriction on the deductibility of interest, you end up having to pay a tax when you may not have had any earnings that year?

Mr. GRADISON. If the corporation has no income, the deduction doesn't mean anything, anyway. I don't mean to play games, but if you mean on a margin, if there is a modest amount of income, clearly he would end up, in the case of a corporation, to take the extreme case, and there are many like this, where they pay out no dividends at all, they are not going to like this, because they are going to lose 20 percent of—they are going to lose their right to deduct 20 percent of whatever interest costs they have and get back nothing in return, because they are not paying out any dividends to deduct, they would reexamine their behavior at that point, presumably.

But as I looked at some of the alternative plans, I see some real problems there, too. One alternative which Mr. Rohatyn and others have alluded to is to say that the high—the bonds that carry high interest rates have an equity element in them, and I suppose that has always been the case, and therefore that some portion of that, some portion of the interest rate on borrowings that carry higher than the normal prime rate, let's say, is really a return on equity and should be denied.

Now, if one follows that to its logical conclusion, the approach would be to say, for example, you can fully deduct up to the prime rate or something like that, but above that, if the prime rate is 5, and your rate is 10, those last 5 points, some portion of that would be nondeductible. That would really bother me.

What that says is that those corporations which pay higher rates because presumably they are less creditworthy, are going to be given a harder time, a more expensive net after-tax cost than the primary companies, and I don't think that that would want to be our goal, either.

I have tried to avoid that by saying, we will treat the interest equally, whether it is the debt of General Motors Corporation, which has very little equity, it has very high quality debt, or whether it is the debt of a new starting company, which is scraped around and financed itself from 12 percent borrowings.

Mr. BROWN. Thank you. I think it is an excellent proposal.

Mr. PICKLE. Let me say, Mr. Gradison, you recommended in your testimony that we ought to have equal treatment on interest and dividends and some way to make it revenue neutral. This is what Mr. Brady was saying this morning in so many words. But I was surprised that you said you had talked to the Joint Tax Committee and that its analysis shows that an 80 percent deduction for interest and dividend payments would be revenue neutral.

Did I understand you to say that you would allow only 20 percent of interest to be deducted?

Mr. GRADISON. No, you would continue to allow 80 percent deductibility. You would allow 80 percent deductibility of interest, and the same 80-percent deductibility of dividends. And they say that that—and it is preliminary and all subject to all the qualifications, I say to my friend, but it would still be 80 percent deductible.

Mr. PICKLE. I am not going to argue on the estimate. But Joint Tax wouldn't give me a figure. They said it is very difficult to estimate. I don't think anybody really knows, and I think the 80-percent deduction or the 20-percent disallowance as you say, is a figure that could be agreeable.

I talked to the Joint Tax Committee, and they would not give me a figure, although they indicated they could in the future. But if there is a figure, the Joint Tax Committee of the Congress, working with the Treasury, ought to say this is fair and keep it in balance. But I don't know whether this figure is correct.

I am just saying that I don't think we have the estimate yet, and that is what we ought to keep looking for. Once you get that figure, then I think you can consider proposals to remove the Tax Code out of the controversy. Until that time, we just don't know.

So I still have reservations about whether your estimate or the 80 percent figure is correct. I just don't think we know.

Mr. GRADISON. I don't know personally. I would very much welcome—indeed, I would invite other organizations which have the capability to do so, to examine the situation and come up with the estimates independent of the Joint Tax Committee, and including the Treasury, and give us their advice.

To be frank with you, when I started into this exercise several months ago, and approached the Joint Tax Committee and had no idea what the number would be, it never occurred to me that it might be possible to continue to allow as much as 80 percent deduction for interest and still end up with a revenue-neutral proposal.

So I have shared—I have used the words carefully in written testimony, because to describe that estimate, it is what Joint Tax told me. I didn't make it up. But it is preliminary, and it is tentative and it needs further work, no argument about that. And I am certainly not asking my colleagues to, at this stage at all, to support the specific recommendation.

All I am asking my colleagues on the committee to do is keep an open mind on the concept, and I gather that the gentleman, if the numbers worked out, might—I am not trying to put words in his mouth—but might find the concept intriguing.

Mr. PICKLE. You do say that their figures were tentative and preliminary.

Mr. GRADISON. That is correct.

Mr. PICKLE. All I am saying to you is that it seems to me we ought to say to the Joint Tax Committee, give us a figure that is not tentative or preliminary, give us your best estimate of what that figure would be.

And then we should ask the Treasury Department, is that agreeable to you? Now, between Treasury and the Joint Tax Committee, we ought to get a figure that we can say we can live with. If we can agree with that figure, we can move forward.

Mr. GRADISON. I look forward to working with the gentleman along those lines. And if you wish to—and you think it is appropriate that we follow up in writing with requests along those lines to Treasury and Joint Tax, I would be happy to join with my colleague in making such a request.

Thank you.

Chairman ROSTENKOWSKI. Thank you, Mr. Gradison. Thank you.

Mr. GRADISON. Thank you for the opportunity. The committee looks a little different from here.

Chairman ROSTENKOWSKI. Mr. Dorgan.

STATEMENT OF HON. BYRON L. DORGAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH DAKOTA

Mr. DORGAN. I will be personally brief, but I want to tell you that the first time I appeared before this committee to talk about this subject was 1981. I was in my first term in Congress. I had introduced a bill that would disallow interest deductions on the very large megamergers. I testified before a subcommittee chaired by Congressman Stark.

I might say that as I listened to Jake Pickle today, throughout the day. Jake comes across as smarter and smarter on these issues; this is an issue on which we share similar views.

Mr. PICKLE. Does that mean I agree with you on something?

Mr. DORGAN. We share a common feeling about this. I have introduced a statement to the committee and will just summarize it. I ask that the statement be made a part of the permanent record.

Chairman ROSTENKOWSKI. Without objection.

Mr. DORGAN. We need to do something. In 1975 there were $25 billion of mergers and acquisitions in this country, last year, $300 billion. This activity has exploded. I know that the hearings talk about LBO's, but I am concerned about a much wider range of issues.

I am concerned about mergers and acquisitions, megamergers, the question of competition. I would like to see us do a number of things. I propose amending the Clayton Act. I propose a series of tests that would be required of corporations to meet in the event that billion-dollar corporations want to merge.

The tests would include such questions as: Does this promote efficiency and new technology and increase employment? I think that there are a whole series of things that we ought to do to make sure that this orgy of hostile takeovers and mergers and acquisitions that we have seen in recent years is slowed.

Now, why is that important? Because I think it injures this country's ability to compete. I asked one of the panelists today, what is going on in Japan? In Western Europe? Are there hostile takeovers? The answer is no.

In Japan, we have government and business working together in a managed economy, trying to determine what kind of combination of public and private policies make sense for them to better compete and more effectively compete around the world.

If hostile takeovers were in their best interests, they would be doing them. It suggests to me that they know what you and I know. If you spend your day trying to figure out how you buy and sell each other and make money, then you don't have a lot of time left in the day to figure out how to make a better product.

I think the Treasury Secretary said it at the end of his testimony. In the long term, we succeed and we win in an increasingly competitive and difficult international marketplace when we build the best products. When that happens, and when we market those products at the most competitive prices, we win.

What does all this merger and acquisition craziness that you read in the financial pages have to do with building better products? Open the newspaper and look at any financial page in the country these days and analyze what it is you are reading. You are not reading about building new products, being on the threshold of new technology, or pushing the frontiers of innovation.

We are reading about who is doing what to whom, who is protecting himself against which raider. I think much of it has to do with greed. This does not, in most cases, have to do with finding some sick puppy on the stock exchange that is undervalued and coming to its rescue and making money by rescuing it.

In my judgment, this has to do with finding an undervalued asset. The marketplace is not a perfect mirror of the underlying realities, and there will always be times when every company is undervalued and overvalued. If you can find an undervalued asset, buy it at discount, you make money, but the issue is making money, not doing business. And that is what I find is a problem with this wild speculation that is going on.

Let me quote one of the more prominent raiders of the day. He was after a company; here is what he said to the CEO: He said, "I am only in this for the money. I didn't know anything about this business; all I care about is the money, and I want it quick."

His point was that he wanted to convert that company's low asset value on the market to immediate profits for him. He didn't care how that company was running, he found a way to make money for himself. I found that counterproductive to the long-term good business sense that we need in this country.

One final point, Mr. Chairman. Let's assume Mr. Brown and I, as I indicated earlier today, own identical companies, have the same employee base, make the same product, have the same fiscal aspects. He is on the left side of the street and I am on the right. But he is a glitzy guy, holding press conferences and advertising everything he is doing. He is attempting to squeeze every single dollar of profit out of that next quarter. That is his only goal. I am more patient. I am building for the long run, making research and development investments, doing the things necessary to build this company's foundation. I'm not quite as glitzy.

The question is, Who is the subject of a hostile takeover? I had the representative of a raider come to see me one day, and I proposed this to him. I said who is the target of the raider you represent? And he said, no question, it is you. The person who does the best job he can for the long term, the long-term business interest, to build the best product, sell at the best price and compete in the long term, that is the person who is the target. That is what is wrong today.

I am not here to defend big companies. I don't think big is always bad and small is always beautiful, but I am not here trying to defend existing boards of directors or existing management. But I am saying that what is happening is counterproductive.

Now, the question is, What should we do? We have had a lot of the best minds of the country here today, and in some respects, it was like horses standing in a burning barn. They say, let's just wait until things get worse or wait until there is a demonstrative study that suggests there is a problem. There is a problem, and I hope that we will in the context of these hearings sift through the best evidence that we can gather on what various solutions might be offered to this country, select the best of those, and attempt to work through a legislative solution.

I want to say thanks to you, Mr. Chairman, for not only calling these hearings, but putting together one of the best lists of witnesses for any set of hearings that I have seen since I have sat on the committee.

[The statement of Mr. Dorgan follows:]

Testimony by the
Honorable Byron L. Dorgan
before the
Ways and Means Committee
of the
U.S. House of Representatives

January 31, 1989

Mr. Chairman:

I am pleased that our Committee is holding these hearings on the the subject of leveraged buyouts and other corporate merger and acquisition activity. I want to thank the Chairman for the opportunity to speak to my colleagues from the perspective of a witness.

I am concerned not only about the leveraged buyouts that we see, but about the whole range of merger and acquisition activity, including hostile takeovers. Today I'd like to make several points about a variety of these issues.

EXAMINING THE PROBLEMS

Our Committee and all the other committees working this session on the troubling and complex issue of merger mania must find a way to put the brakes on the merger and acquisition craze that it sapping our country of its economic energy. We must not wait for the crisis to hit before we act. We must examine the problem thoroughly, assess the consequences of a variety of legislative solutions, and take action. If we wait too long, we might have to operate under crisis conditions. I'd rather see Congress make tough decisions now, than have debt-loaded corporations that have gone bankrupt during a recession come before this Committee later with their explanations of what went wrong and ask for a change in government policy.

AMERICAN COMPETITIVENESS

My concern about the merger orgy stems from the belief that it directly impacts on our nation's ability to compete in the world. Corporate America should be focusing on how to put our country back in the driver's seat in international trade with better products, more efficient production, competitive prices, and expanded markets. Instead corporate America is preoccupied with devouring other corporations or trying to prevent being devoured. Our nation is drowning in a sea of takeovers, mergers, acquisitions, leveraged buyouts, junk bonds, and crushing corporate debt.

SHORT-TERM GOALS

I recently spoke with a CEO of a major company about the current trend in corporate America to concentrate only on short-term results instead of long-term planning. I asked him how two hypothetical companies would be evaluated by the market. I said, assume that we produce the same products and have been in business about the same amount of time with identical companies. I look to the future and plan for a stable growth. I invest in plant and equipment and put money into research and development so that I can produce a better product. My liquidity is sound. On the stock market my assets end up being undervalued.

My competitor across the street looks only to the short term. He's not worrying about new plant and equipment or R&D. He just wants to boost his stock price as high and as quickly as he can. He is extracting every bit of short-term profits out of his assets. He is glitzy. He is all over the nightly news broadcasts, and Wall Street responds.

I'm following sound business planning principles and my competitor is not. Who is the more attractive target of a takeover? I am. Because the undervaluation of my company's stock makes me the vulnerable one, even though I have paid attention to basics and built for the future.

· EFFECTS OF THE RAIDER WAR

We will hear some argue today that mergers, acquisitions, and takeovers are generally beneficial. The evidence shows otherwise. Let's look specifically at hostile takeovers and their impact.

It's the well-managed, not poorly-managed companies, that are the targets. A company that can support a high debt level, has good cash flow, and with strong assets to sell off is the one that's attractive to a raider. Let me remind my colleagues that these companies are not the target of only American companies, but foreign ones as well. As a GAO study I requested recently showed, foreign hostile takeovers of American firms, while still a small percentage of the total picture, are definitely on the upswing.

Most takeovers convert equity into debt and thus weaken a company's ability to withstand an economic downturn. Moreover, capital expenditures are delayed in order to service the debt. Research and development suffer. In short, it's bad for American business.

Some argue that takeovers help remove inefficient managers, but that's not generally the case. More often than not the takeover attempt is made simply to put a company into play to be bought out in a recapitalization. Ask T. Boone Pickens how often he's taken control.

Workers and communities often lose in the takeovers. As a company retrenches to pay down its debt employees lose their jobs. Morale among workers is harmed which in turn hurts the company's performance. The tax base of communities suffers as the repercussions of unemployment are felt.

CORPORATE DEBT

Corporate debt is enormous and growing. Kohlberg Kravis Roberts & Co. (KKR) and the RJR Nabisco $25 billion deal should make us all wonder just where corporate America is going. The ease with which corporations incur debt is mind boggling. It's hard to explain to my constituents why they cannot qualify for a loan on a modest home with their hard-earned savings and KKR can go out and get loans for a $25 billion deal. In the last five years the debt of non-financial corporations has gone up by over $800 billion and equity has shrunk by over $300 billion. The most risky forms of this debt are junk bonds. In the event of a default they will have major repercussions on insurance companies, pension funds, savings and loans, and banks. As some bank analysts have noted the LBO loans of today could be the LDC loans of tomorrow. Corporate debt of all varieties is a ticking time bomb that will explode with a recession.

TRANSACTION JUNKIES

One other aspect of this merger, acquisition, and takeover activity that disturbs me is the matter of greed. There's a driving force behind much of this activity that we should not underestimate. Fees racked up by many Wall Street firms in this M&A war are grossly inflated. KKR will get a $7.5 million fee for its part in arranging bridge financing alone for the RJR Nabisco deal. In the Pickens-Unocal deal the investment bankers raked in a cool $50 million. The prospect of a huge commission is a driving force behind some of these "transaction junkies" who will chase any deal even if it makes no economic sense.

A SAMPLE OF LEGISLATIVE APPROACHES

How can Congress address this array of complex issues? We need to move with care, but we need to act before we face a crisis situation. I suggest several approaches to the problems that I've discussed, particularly in the area of hostile takeovers.

CORPORATE RAIDER TAX

First, the tax code tends to favor debt and has made it easier for this kind of activity to continue unabated. What do we do about the tax code's favoring of debt? I introduced H.R. 158, the Corporate Raider Tax Act of 1989, which will disallow the interest deduction on indebtedness incurred or continued to purchase or carry stock acquired as part of a hostile takeover. It also requires the puchaser of stock in any hostile stock purchase be treated under the Code as if the acquired corporation had sold all its assets for their fair market value and then liquidated.

SHAREHOLDER DEMOCRACY ACT

Second, in the securities area I introduced the Shareholder Democracy Act, H.R. 2996, in the last Congress and I will re-introduce it this session. This bill aims to discourage hostile takeovers primarily through enhanced disclosure and democratic rules. My goal is not to discourage those who buy with the intention of creating a better company but rather to stop those who take to plunder and sell.

The bill would accomplish this goal by requiring a variety of changes such as: a longer waiting period, 60 days, between initiation and consummation of an unsolicited bid; the consummation, but not the commencement, of a tender offer be approved by the stockholders of both the bidder and the target; the disclosure of the economic effects of the bidder's proposal, similar to those in registration requirements; the disclosure of the accumulation of ownership within two days, instead of ten, when a person or institution acquires two percent, instead of five percent, of a company's common stock.

This bill will not stop all takeovers but it will lay out the rules of the game more clearly so that the public interest will be better served.

MERGER LIMITATION ACT

Finally, I will re-introduce H.R. 3090, the Merger Limitation Act, which will slow down the pace of mergers and look out for the public interest. This bill amends the Clayton Act's Section 7 by requiring that mega-merger deals pass a test before they will be allowed to proceed. Before a corporation can acquire more than ten percent of the stock or assets of any billion-dollar corporation it must prove to either the Federal Trade Commission or the Assistant Attorney General that the acquisition, among other things, will not substantially lessen competition; will create long-range efficiencies in the product or service; will be in the long range best interest of the consumer; will benefit foreign competitiveness; and will not create a dislocation for communities and workers.

CONGRESSIONAL RESPONSIBILITY

The message that I would want to leave with my colleagues today is that mergers, acquisitions, LBO's, takeovers and the other games that corporate America is playing do not exist in a vacuum. Some observers tend to look at this problem as if the only people affected are the stockholders and the managers. Each and every American is affected by this merger mania. The public interest is at stake.

It's our responsibility to study this issue in all its complexity and make careful decisions about how to proceed. We must be mindful that we create rules that level out the playing field. It is not our intention to give foreign corporations any advantage over our domestic corporations. But, we do intend to stop the madness.

Our major goal should be to protect the public from the repercussions of this merger and acquisition activity and ensure that we prevent a crisis from occurring. The last thing we want to do is sit here a few years from now in the midst of a recession and wring our hands and shake our heads about how we might have prevented the unfortunate results of merger mania and the leveraging of corporate America.

Chairman **Rostenkowski.** I think that there is a genuine feeling of concern, and I don't know that anybody has the solution, and I think that it is going to take a great deal of concentration, if there is a solution, for us to put something together that ultimately won't have this committee wear the jacket, so to speak, for a downturn in the economy, such as we had on Black Tuesday, which I think is the most ridiculous accusation that I have ever heard.

But what I am proud of most in this committee is that we recognize that there are possibilities for just exactly what has happened. We tried on several occasions to come up with revenue, only to be turned back by Senate conference. But I think there is a new atmosphere that exists on the other side of the building now, and let's hope that we can do the right thing.

Thank you very much. The committee stands adjourned until 10 tomorrow morning.

[Whereupon, at 5:05 p.m., the committee adjourned, to reconvene at 10 a.m., Wednesday, February 1, 1989.]

TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

WEDNESDAY, FEBRUARY 1, 1989

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to notice, at 10:06 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. The committee will come to order.

This morning, we continue our comprehensive review of issues related to leveraged buyouts and other transactions that result in corporate equity being replaced by debt. Yesterday, we had the opportunity to receive testimony from the Secretary of the Treasury, other Government policymakers, business economists, and dealmakers. We heard a wide range of opinions regarding the economic impact of LBO's, and we discussed several preliminary legislative approaches to these issues.

Today we will hear from other witnesses notable in business, education, and Government. Also, we will receive testimony from representatives of labor unions regarding their specific concerns.

Our first witness, to be followed by Dr. Henry Kaufman, is our colleague of longstanding, an outstanding Member of the House of Representatives from the State of Florida, Charles Bennett.

STATEMENT OF HON. CHARLES E. BENNETT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. Bennett. Thank you very much. I thank you and the committee as a whole for allowing me to be here, and for allowing me to speak on the very important issue of leveraged buyouts.

Prior to about 1984, most leveraged buyouts involved medium-sized companies, and perhaps in many cases, there was some merit in what happened. Since then, the "thirst" of corporate raiders has become insatiable among money managers and the deals continue to grow in size and complexity, as evidenced by the recent RJR Nabisco leveraged buyout.

Money managers have now seized an opportunity to capture large corporations by buyouts in a way which enriches the money managers, but which may endanger the future of the corporations acquired. Our present Federal Tax Code has inadvertently provided a subsidy to these money managers by allowing unrestricted deductions for interest paid on the debt incurred to buy out a corporation's stocks. Some experts see these tax deductions as one cause for the growing proliferation of such transactions over the past few years. Unfortunately, as the size and number of buyouts increases, the cost to the American taxpayer also increases. I do not need to remind anybody here about the size of the Federal debt. We cannot afford to have the Government unnecessarily subsidizing these large corporate buyouts, which in many instances do not themselves result in a healthier corporate structure.

To get the Federal Government out of the business of subsidizing these large corporate buyouts, on January 24, I introduced H.R. 615. This bill limits the amount of interest that a corporation may deduct when the interest arises out of debt incurred to buy out the stock of another corporation. Committee members may recognize this bill, or at least portions of it. Similar language was in last year's reconciliation package, but dropped probably because of lack of full hearings on the subject. It is worthy of passage as a freestanding bill, and that is the force of H.R. 615.

H.R. 615 does not completely eliminate the interest deduction allowed on debt incurred on a corporate buyout. However, it sets a reasonable annual cap of $5 million on the amount of interest that may be deducted for debt incurred to buy out the stock of another corporation. The reason for having a cap rather than a complete prohibition is that some of the smaller transactions may have valid economic purposes. This cap would protect that, while giving moderate help, up to $5 million, to even greater sized ventures. In these days of Federal deficits, a reasonable annual limit makes good government and makes good sense.

H.R. 615 does not interfere with the deductions for asset acquisition. For example, a business person who incurs debt to buy a construction company and all of its equipment is still entitled to deduct the interest paid on this type of acquisition debt interest. By doing so, this bill does not discourage productive acquisitions, nor is that the intent of the bill. This bill may discourage some leveraged buyouts. If it does discourage some leveraged buyouts, it does so only because the money managers are no longer getting a free ride from the Government, and not because of any governmental limitation imposed by this bill on a valid buyout project.

Some people have argued that if there is a limitation on the tax deductibility of corporate interest payments on leveraged buyouts, there should be a reduction in taxes imposed on stock dividends. There is no connection between the two issues. There may be some logic to reducing taxes on dividends, but arranging the tax law in that way would only increase our already frighteningly high Federal deficit. It would tend to help the rich at the expense of the poor.

Who would benefit from a proposal to reduce taxes paid on stocks? Not the Treasury, not middle America, not the poor—but the rich. This is certainly not the time to help the rich at the expense of the poor in this country when our country is so deeply in debt. That would be bad Government and bad sense.

My proposal is not a new tax or a tax increase. It is getting rid of a loophole, and a bad loophole at that.

An amendment to the Tax Code to get rid of unlimited Government subsidies for leveraged buyouts is an idea whose time has come.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Statement in Support of H.R. 615
by Congressman Charles E. Bennett
Before the House Ways & Means Committee

Mr. Chairman:

Thank you for this chance to speak today before the committee on the very important issue of leveraged buyouts.

Prior to about 1984, most leveraged buyouts involved medium sized companies and perhaps in many cases there was some merit to what happened. Since then the "thirst" of the corporate raiders has become insatiable among managers of money, not just industrialists; and the deals continue to grow in size and complexity (as evidenced by the recent RJR Nabisco leveraged buy out).

Money managers have now seized an opportunity to capture large corporations by buyouts, in a way which enriches the money managers, but which may endanger the future of the corporations acquired. Our present federal tax code has inadvertently provided a subsidy to these money managers by allowing unrestricted deductions for interest paid on the debt incurred to buy out a corporation's stocks. Some experts see these tax deductions as one cause for the growing proliferation of such transactions over the past few years. Unfortunately, as the size and number of buyouts increases, the cost to the American taxpayer also increases. I do not need to remind you of the size of the federal debt. We cannot afford to have the government unnecessarily subsidizing these large corporate buyouts, which in many instances do not themselves result in healthier corporate industry.

To get the federal government out of the business of subsidizing these large corporate buyouts last week I introduced H.R. 615. H.R. 615 is a bill to limit the amount of interest that a corporation may deduct when the interest arises out of debt incurred to buy out the stock of another corporation. Committee members may recognize this bill--similar language was in last year's reconciliation package, but dropped probably because of lack of full hearings on the subject. It is worthy of passage as a free standing bill and that is the force of H.R. 615.

H.R. 615 does not completely eliminate the interest deduction allowed on debt incurred on a corporate buyout--however it sets an annual cap, of 5 million dollars, on the amount of interest that may be deducted for debt incurred to buy out the stock of another corporation. The reason for having a cap rather than a complete prohibition is that some of the smaller transactions may have a valid economic purpose. This cap would protect this, while giving moderate help (up to $5 million) even to greater sized ventures. In these days of federal deficits a reasonable annual limit makes good government and makes good sense.

H.R. 615 does not interfere with deductions for asset acquisition. For example, a business person who incurs debt to buy a construction company and all of its equipment, is still entitled to deduct the interest paid on this type of acquisition debt interest. By doing so this bill does not discourage productive acquisitions, nor is that the intent of the bill.

This bill may discourage some leveraged buyouts. If it does discourage some leveraged buyouts, it does so only because the money managers are no longer getting a free ride from the government, and not because of any governmental limitation imposed by this bill on a valid buy out project.

Some very brilliant and very thoughtful people have urged Congress not to tamper with the tax deductibility of corporate interest payments on leveraged buyouts, and have offered, as an alternative, proposals to reduce the taxes stockholders pay on dividends.

These people argue that by reducing the taxes stockholders pay on dividends, companies may rely on selling stocks to raise money, rather than borrowing money. There may be some logic to that position--however by that course the government would continue to subsidize leveraged buyouts, and also reduce the revenue the government receives from taxing dividends. Arranging the tax law in that way would only increase our already frightenly high federal deficit.

And who would the winners be under any proposal to maintain the LBO government subsidy while cutting dividend taxes? Not the treasury, not middle America, not the poor--but the rich. This is certainly not the time to help the rich at the expense of the poor in this country when our country is so deeply in debt. That would be bad government and bad sense.

An amendment to the tax code to get rid of unlimited government subsidies for leveraged buyouts is an idea whose time has come.

Chairman ROSTENKOWSKI. Are there any questions of Mr. Bennett?

Mr. PICKLE. Mr. Chairman, all I want to do is just compliment our colleague for his testimony.

Mr. BENNETT. Thank you.

Mr. PICKLE. And for the brevity of his testimony. Mr. Bennett is one of the most senior and one of the most respected Members of this House, and whether his cap is the best approach, I do not know. But I think the members of this committee share your feeling that something should be done, and your suggestion is certainly one we will take into consideration.

Mr. BENNETT. Thank you very much.

Chairman ROSTENKOWSKI. I want to thank you, too, Mr. Chairman, for joining us and sharing your views with us.

Our next witness is Dr. Henry Kaufman.

Dr. Kaufman, it is always a pleasure to have you here with us, and I want to express my personal gratitude. Whenever we have asked to have you share with us your views, you have always been available. I want you to know that that means a great deal to us here on the Ways and Means Committee.

STATEMENT OF HENRY KAUFMAN, PH.D., PRESIDENT, HENRY KAUFMAN & CO., INC., NEW YORK, NY

Mr. KAUFMAN. Thank you very much, Mr. Chairman.

I am very pleased to be here to present my views on this very important subject. I have submitted to you a detailed statement, which I will not read, but I do want to summarize some of the more important aspects before this committee today.

I believe that the shift away from equity toward debt financing by business corporations really poses significant dangers to the economic and financial well-being of this country. There are seven problems associated with this, and let me just enumerate them.

First, I think this trend creates a real threat to the financial viability of business corporations, especially when we go into the next business recession and economic decline.

Second, this trend of substituting debt for equity undermines the basic strength of the equity market. It initially, of course, supports stock prices with all of the guessing as to who will be bought next and financed out next through debt financing. But when we get into an economic decline, this kind of financing will terminate as the risks increase, and you will find that the current debt buildup will accentuate the decline in equity prices at that time.

Third, it does permanent damage to the corporate bond market. As a result of this, long-term financing costs for all corporations are rising. There is an increasing shift to short-term and intermediate maturity financing. Thus, the bond markets, that have been one of the cornerstones of the American financial system, are diminishing in importance, and short-term and intermediate financing is increasing in importance.

Fourth, this trend makes it very difficult for the Federal Reserve to stabilize the business cycle without precipitating very wide swings in interest rates. The next time the economy slides, this kind of financing that is taking place will require that the Federal

Reserve act promptly, lowering interest rates very sharply in order to arrest the potential negative impacts on the economy.

Fifth, I strongly believe that it weakens the competitive position of U.S. business corporations internationally. Our corporations are losing credit standing, while the creditworthiness of German and other European business organizations is increasing their financial strength. The same is true, of course, in Japan.

Sixth, it certainly decreases the revenue of the U.S. Government and, therefore, increases the budget deficit.

Seventh, and I believe most importantly of all, this will cause a significant shift in the financial and industrial relationships that exist in the United States.

The seventh point that I am making here probably is the most critical one for the Government to pay attention to. This is because these changes in the shift of financing from equity to debt will ultimately result in a much more intimate relationship between financial institutions and business corporations.

It has been the history of American finance that there is always an independence between the business side and the financial side. The business corporation went to the banker when he needed funds or to the investment banker, and that was it. But there was never a truly intimate relationship of the kind that we have seen in Europe and in Japan.

The pathology of this situation is that over a period of time, as this shift from equity to debt persists, financial institutions are going to play a much more intimate role in the lifestyle, in the strategy of business corporations themselves. And with that will come the need for an increasing involvement of the Government in the entire process.

That is the insidious nature of the creation of debt and the substitution of debt for equity. This is a gradual process. Even if you do not admit to the dangers that I pointed out in my other five or six points, it is this gradual seeping danger that will eventually change the financial structure and the financial relationship to business corporations. This is the issue, I think, that is most important to Congress at this point in time.

Now, let me also summarize what I believe are perhaps some of the suggestions that ought to be considered by Congress in dealing with this problem. I believe that there are no perfect solutions to this particular issue. But having no perfect solutions does not mean that there should be no actions, because the trend that I have sketched will continue.

There will not be a natural end to this process. The competitive pressures to do these deals are too great. The rewards to do these deals are too great. But there are a series of potential solutions that ought to be considered by Congress and by the regulators as we go forward. I have just a number of them. I have 10.

First, I think the Government ought to reconsider double taxation of dividends and consider eliminating the double taxation.

Second, there is a need, really, to review capital gains taxation and to modify it: to eliminate the capital gains taxation for long-term gains altogether, and to have a higher tax rate for capital gains short term, let us say within 1 year.

Third, the capital requirements of financial institutions providing the financing for these deals should be scrutinized far more closely. Any system of risk-based capital standards ought to treat especially strictly those deals that involve huge quantities of debt and that depend heavily on locating eager buyers to purchase the subsidiaries the borrowing company intends to spin off to help repay the bank loans.

There are already capital requirement standards for the commercial banking system, but those can be reinforced and can be reinterpreted by the regulators involved in order to have greater scrutiny over this kind of activity.

Fourth, beyond the formal application of impersonal numerical ratios, the central bank ought to be involved at the personal level with the bank management, playing a leadership role in pressing for a return to conservative banking principles which are all too often neglected in this kind of activity.

To take one illustration that should involve the central bank, the syndicators of LBO loans should accept the responsibility ongoing to the institutions that participate in this financing.

Fifth, I believe it is questionable whether any Government-insured deposit should be allowed to be invested in these loans or in junk bonds that are then issued to retire them. If banks and thrift institutions choose to participate in this kind of financing, I believe it ought to be in separate affiliates, separately capitalized, not funded with insured deposits.

Sixth, security firms should not be allowed to underwrite securities for firms in which they have a direct stake themselves, whether an equity stake or a bridge loan. Even disclosure of these kinds of positions is insufficient to check potential abuses and to check the potential conflict of interest inherent in this process. After all, how can an investment banking firm do objective due diligence for the securities to be distributed to the public when the proceeds of the offering will pay off a bridge loan in the securities firms' own holdings?

Seventh, I believe bond holders in the existing securities of the firm should be given an explicit legal right to sue the organizers of an LBO or other corporate decapitalization for damages ensuing from the resulting downgrading of the credit ratings of those bonds caused by that restructuring.

The current process that is in place today subsidizes marginal borrowers as a result of the credit standing of very high-rated borrowers in the United States. Now, that is not only an inequity in the system, but it is a system that continues to promote marginal debt.

Eighth, whenever the management of a company makes a bid for its company, there should be an immediate inquiry as to whether the group is utilizing inside information not disclosed to the shareholders. There ought to be a written explanation published why the business plan that the group intends to adopt after the LBO cannot be pursued as a publicly held company.

Ninth, it seems to me that sufficient time, perhaps 90 days, should be provided for other bidders to compete whenever members of an existing management propose an LBO.

Finally, while I do not favor measures that directly limit the participation of the foreign institutional lenders who have been extremely important in the financing of many merger transactions, nevertheless, some restraint should be exercised by them. Here, regulatory authorities of the U.S. and other major countries have already made some progress in developing uniform capital standards for banks. But that is not enough. It would make sense to extend these efforts to include explicitly the treatment of merger and LBO financing.

Furthermore, I doubt that any major industrial country would want to be identified as a prominent source of funds facilitating the decapitalization of American enterprise. A continuing dialog ought to be encouraged on this matter between the United States, between the U.S. Treasury and the U.S. central bank and other foreign official institutions. I believe this would go a long way in harmonizing lending practices in this area.

We live today in global financial markets. We cannot deny that. And as a result of this, we must have our official institutions work closely in coordination with foreign institutions on this particular issue. Otherwise, the financing will go offshore, and very little change will materialize.

Let me stop here, Mr. Chairman, in my testimony. My complete testimony, I believe, has been distributed to you.

[The statement of Mr. Kaufman follows:]

Statement by Henry Kaufman
President
Henry Kaufman & Company, Inc.

Before the Committee on Ways and Means
United States House of Representatives
Washington, D.C., February 1, 1989

Mr. Chairman and Members of the Committee. My name is Henry Kaufman. I am President of Henry Kaufman & Company, Inc., a money management and financial consulting firm that I established last year, after spending over 26 years with the firm of Salomon Brothers.

I am pleased to be able to accept your invitation to present my views on an important subject that has justifiably drawn the attention of both the Congress and the senior leadership of the new Administration -- the decapitalization of American corporations. In recent public statements, I have expressed my own concerns about the disturbing disregard for capital that is permeating some important segments of American business. It is a phenomenon that threatens our nation's economic well-being.

The disregard for capital is not limited to the corporate sector. There are other manifestations. It is present in the exorbitant demand for credit on the part of the Federal Government that results from an inability to make necessary budgetary reductions. It is also seen in a continuing rise of personal indebtedness by the household sector.

But it is the prolonged, and highly undesirable, shift away from equity towards debt financing by many business corporations that is especially worrisome now. This shift has accelerated in recent years as a result of the corporate merger, acquisition, and leveraged buyout mania which, in a number of ways, has heightened the disregard for capital. I believe that unless something is done to forestall excesses that are almost inevitable in this area, the health of the free enterprise system in the United States will be endangered.

To some, this may seem to overstate the menace. But the merger, acquisition, and leveraged buyout mania poses significant hazards for a number of reasons:

- o First, it creates a real threat to the financial viability of the corporations involved. That threat will become harshly apparent to everyone in the next recession, whenever that may come.

- o Second, it serves to undermine the basic strength of the stock market. In the short-term, it distorts normal trading activity as market participants become increasingly obsessed with uncovering where the next deal will come from. For the longer term, it erodes investor confidence in the underlying fairness of the markets. And from a cyclical perspective, the exaggerated dependence of the market on mergers, acquisitions and buyouts will end up contributing to a sharper decline in share values when the next recession draws nearer.

- o Third, it does permanent damage to the corporate bond market. As a result, the cost of long-term debt financing will rise for all business organizations, even those not directly involved in M&As or LBOs themselves. And that will encourage still shorter maturity financing to escape the high cost of long-term funds, aggravating corporate financial vulnerability.

- Fourth, it weakens the competitive position of U.S. business internationally. That is because over a period of time the large increases in leverage and debt servicing that accompany corporate financial restructurings will make it more difficult for many U.S. firms to embark on essential investment projects. But corporations in the other major industrial countries are improving their balance sheet positions -- and hence their capacity to finance productive investments and sustain their competitive strength.

- Fifth, it decreases our Government's revenue and thus increases the budget deficit.

Now, I would not go so far as to assert that all highly leveraged corporate restructurings are unwise. Some may well yield positive economic effects. But taken too far, the decapitalization of American corporations will cause future financial stress. Ultimately, it will put the Government into the business of business through bailouts that will move our system closer to a social, and away from an economic, democracy.

This variant of socialization probably will not happen suddenly, as the outcome of some dramatic shock. Instead, the pathology of excessive leverage is to infect the system slowly, with few immediate overt symptoms of financial disease. But once underway, the infection is virtually impossible to reverse. It will cause profound changes in the system, amounting to a major upheaval in our economic and financial way of life. Excessive leveraging will encourage a growing concentration of assets and of decision-making in the private sector.

Out of that will emerge a financial-industrial complex wherein financial institutions and industrial corporations become increasingly interwoven, rather than separate and distinct entities. That amalgam will invite various forms of Governmental intrusion, culminating in direct Government participation in business through bailouts of corporations that fall into severe financial difficulties.

But for now, and possibly for some time to come, these long-term adverse consequences for the country will either be ignored or dismissed. Unfortunately, the immediate financial rewards to the participants in the game are so large and tempting that a whole series of self-justifications have come forth in favor of these deals. Thus, more and bigger deals will continue to be pursued until either there is a major failure or until Government steps in to check the excesses that will inevitably occur at some point.

DIMENSIONS OF THE PROBLEM

There is no clear consensus on why precisely the M&A and LBO mania is happening right now, whether it is an indictment of a generation of ineffective management, an incorrectly structured tax system, a natural result of loose, abundant credit, or an outgrowth of our weakened international financial position. Doubtless, many factors are responsible. But there is no dispute that it is contributing to a decapitalization of U.S. business which is proceeding at a rampant pace.

It entails a staggering substitution of new debt for outstanding equity. Over the past five years the debt of U.S. nonfinancial corporations has gone up by an estimated $840 billion and the equity position has contracted by nearly $300 billion.

In the latest economic expansion, nonfinancial corporate debt has grown by 15.4% annually. This compares with an annual increase of only 8.4% for the previous six cyclical periods of economic growth.

In the process, interest payments by U.S. nonfinancial corporations have swelled to a point where they now amount to about 26% of internal cash flow. To put this number in perspective, these payments now preempt more internal cash flow than during the recessions of 1982 and 1974 when this ratio was 22% and 19%, respectively.

One price of this leveraging explosion is a severe drop in credit quality. Last year was the seventh consecutive year in which there were more downgradings in ratings by the major credit services than upgradings. As a result, only a handful of major corporations are still rated AAA, and the number of A and AA rated companies is also dwindling.

Some claim that the merger, acquisition and leveraged buyout activity imposes limited systemic risks as long as it involves non-cyclical businesses, those which presumably produce a steady cash flow. This is a substantial overstatement of the facts. Even non-cyclical businesses are adversely affected by downturns in economic activity, though not as much as heavy industries.

In this connection, the new dimensions of the interaction between monetary restraint and its impact on economic participants are not taken into consideration. In our new deregulated financial world, for the central bank to achieve effective restraint, it must force a denial of credit at a much higher level of interest rates than when markets were more segmented. Monetary restraint is successful only after considerable scrambling for credit takes place among businesses, households, and government. Thus, many so-called non-cyclical businesses will become more bruised than heretofore, including consumer goods, retailing, and service industries.

Moreover, the so-called cyclical sector has not been a small proportion of the merger and leveraged buyout activity. According to a recent study by Goldman Sachs, corporations in cyclical industries accounted for nearly $200 billion or 40% of merger and acquisition activity and for $35 billion or again 40% of the leveraged buyouts since 1982.

What is important to bear in mind is that this decapitalization of so much of American industry has come into vogue under relatively benign economic conditions. The weakened financial structure of many corporations has not been tested during a business contraction. When it comes, there will not be the swollen sales, revenues and corporate income readily available to service a bloated mass of debt that there is today. Consequently, the chances are high that companies with a highly leveraged capital structure will report losses that are much larger than normal in a cyclical economic downturn. For quite a few, cash flow will be inadequate to service debt. For many, there will need to be various kinds of reschedulings and workouts to avoid bankruptcy proceedings.

By then, the issue will be raised in a political context of whether the nation is prepared to accept the full discipline of the marketplace to exorcise these excesses of leverage. Will firms who took on massive amounts of debt be allowed to fail, even if that would threaten to worsen the business contraction? Or will there be a clamor for a safety net, a lender of last resort in the form of a governmental bailout? After all, many who are now perpetuating the M&A and LBO mania will be suffering acutely -- lenders with fiduciary responsibilities, banks, pension funds, insurance companies.

For the Federal Reserve, the dilemma of how to conduct monetary policy during the next recession for an economy laden with heavily indebted corporations will be especially acute. We have to ask: To what extent will our central bank have to accelerate monetary ease to avoid an immediate financial calamity -- even if that means prematurely reigniting inflation and seriously damaging the prospects for a non-inflationary recovery? And, if the central bank routinely accommodates the bailouts, will it not end up being little more than an accomplice in encouraging the drift toward a socialization of economic and financial activity?

The international consequences of the explosion of corporate debt are no less worrisome. Just at a time when this nation is trying to regain international competitiveness so that we can improve our trade position, the additional debt burdens on many companies will have a crippling effect. In contrast, financial positions of major corporations abroad are getting stronger. In Japan, for instance, large increases in retained earnings have lowered corporate debt to equity ratios by some 10% in the past two years. A general pattern of improving equity positions is common throughout Europe, as well.

The proponents of an uninhibited market in corporate control, those who applaud the M&A, LBO mania, dismiss these concerns. Debt poses no burdens, they contend; if economic adversity ensues, debt is easily restructured. Leverage ratios are of little concern; companies in Europe and Japan have long had higher debt-equity ratios without adverse consequences. Monetary policy need not be influenced by corporate debt; it merely substitutes for debt that would otherwise have been accumulated by the household sector. And, the proponents assert, managements of companies will find it easier to pursue long-term strategies when they don't have to be subservient to the short-term time horizons of people in the stock market.

I find these assertions unconvincing. High levels of debt create fragility and a far greater vulnerability to economic shocks -- unless society is willing to go along with the kind of close, even intrusive, banking and government involvement in industry that is institutionally embedded in countries such as Germany or Japan. But for our institutional setting, there is ample historical evidence supporting the financial dictum that a large equity position allows corporations to assume greater risks and to pursue opportunities that debt-heavy corporations must forego. Moreover, I know of no groups of shareholders who today are standing in the way of the management of a publicly traded corporation moving to improve the long-term efficiency of the firm. Shareholders do not resist these efforts; they yearn for them.

To argue that managements without shareholders but with huge amounts of debt somehow have more flexibility to achieve positive change in a business strikes me as both disingenuous and historically inaccurate.

PRESSURES FOR PERPETUATING HIGHLY LEVERAGED ACTIVITIES

Nevertheless, the unfortunate truth is that nearly all parties involved in the M&A, LBO mania have a strong vested interest in its continuation.

- o Existing members of management normally have stock options which can be cashed out at high premiums. Plus in a management buyout, they get substantial portions of the equity in the new entity on which further profits can be recorded.
- o Most stockholders are passive and enjoy the instant gratification of the high premiums paid by the bidders, and take their money elsewhere.
- o Commercial bankers get high fees for organizing and participating in the loan syndications. They get substantial interest rate spreads over the prime lending rate. In this day and age, when competition for credits is extremely fierce, these deals are nearly irresistible for the banks, regardless of the risks involved.
- o Investment bankers and lawyers get high fees as advisers, so lucrative that it is very difficult for them to be objective in identifying the negative aspects of the deals they are pushing.
- o In many instances, the investment bankers also stand to benefit twice over as underwriters and sellers of debt securities in the public markets that are usually required to pay down the bridge loans, part of which are domiciled on the investment bankers' own books.

About the only stakeholder that is plainly an instant loser is the holder of the existing bonds of the company. Frankly, the bond holders do not have a strong enough constituency to get themselves bailed out or a clear enough legal standing to prevail in the courtroom for financial damages.

The class of instant beneficiaries also includes the equity market at large. To the extent that shares are withdrawn, that tends to make market prices elsewhere higher than they would otherwise be. In addition, the M&A, LBO mania sets off a scramble to find the next potential candidate to go through the process, and their share prices are bid up substantially. In fact, a good part of the strength in the U.S. equity market today can be traced to the phenomenon. Other, more stable sources of demand for stock have largely retreated from the market, especially pension funds and individual investors with long-term horizons. The scent of the deal and the short-term killing that can be made in anticipating the next LBO or M&A has replaced other considerations. What it means is that for the time being the equity markets have almost become addicted, and any measures aimed at slowing down the tempo of M&A and LBO activity is bound to weaken the prices of equity in general.

WHO ARE THE DEFENDERS OF CAPITAL?

In view of this relatively new behavior of management, investors and financial institutions, it is appropriate to ask: "Who is the defender of capital?" It had been generally believed that it was business and investors who naturally exercised that responsibility. Much seems to have changed. The role of the powerful large individual stockholder manager has diminished. New stockholder groups have frequently avoided a participatory evaluation of management. In most instances, the important new class of stockholders -- institutional investors -- tends to sell their shares rather than question management decisions. Moreover, the institutional portfolio practices of our day stress modern portfolio theory and equity risk diversification, not stockholder-management involvement. As a result, corporate managements are often independent trustees of a sort for a silent and absentee stockholder group.

The role of the institutional lenders, such as banks, has also shifted away from being the defender of capital to being financial entrepreneurs. They frequently resist the call for higher prudential capital ratios and more conservative accounting standards. Government-insured deposits, a technique for obtaining low-cost funds, have financed all sorts of marginal lending in an attempt to capture large profits.

Isn't it rather startling to find that before the loan problems of the LDCs and of the thrift institutions have been put to rest, the financial markets are enveloped in another speculative financing binge? Yet, the way our current world of institutions and markets are now structured, they cannot avoid being caught up in the creation of marginal debt. Today, even the most conservative institutions compromise standards and engage in practices that they would not have cared to pursue a decade or two ago. The heroes are the daring -- those who are ready and willing to exploit leverage, and risk the loss of credit standing, to revel in the present casino-like atmosphere of the markets.

With the onslaught today of financial deregulation, innovation, and new technology, it is impossible for institutions and markets to be the defender of capital. Consequently, it is the Government as the representative of all constituents that must assume this urgent role.

We all must begin to appreciate that corporate debt can never be a full substitute for equity. Debt involves defined corporate obligations of interest payments and repayment schedules. It is a preemptive factor in corporate cash flow and may limit management flexibility. The abuse of the debt-creation process contributes to corporate failures, and for society as a whole runs the risk of debauching the essence of economic democracy. Equity, in contrast, allows freedom of decision-making and often reflects confidence in society and its political and economic institutions. If we diminish the role of equity, we invite the spectre of business control first shifting to financial institutions and then inexorably toward government. In the process, we risk a social and political change away from freedom.

THE CASE FOR A GOVERNMENTAL RESPONSE

For its part, the Government has two good reasons to respond promptly to the escalation of high leveraging within the corporate sector.

First is the straightforward adverse revenue effect on the U.S. Treasury. Decapitalization substitutes tax deductible debt for equity, so over time corporate taxable income will be lower than it would otherwise be. To be sure there are partial offsets. Some existing stock is held by people who pay capital gains taxes, and the lofty premiums paid by bidders will generate one-time capital gains collections. And some of the new junk bonds will be issued to taxpaying individuals and institutions. But over the long haul, the cumulative effect of an unchecked movement from equity to debt will permanently and substantially reduce corporate tax collections by tens of billions of dollars. Thus, the Government is subsidizing decapitalization of U.S. industry.

Second, and probably more important, the Government has to be concerned that the weakened financial structure of corporations effectively leaves it with the implicit burden of having to come to the rescue of failed companies the next time the economy turns downward -- or else risk a major national financial catastrophe.

If the market cannot discipline itself, then the Government will have to consider means of inserting the necessary disciplines. It is no excuse to shy away from action on the assertion that no feasible set of restrictions will be perfect. Of course not. But just because what can be done will be imperfect doesn't mean nothing should be done.

TOWARD A PROGRAM OF PRUDENT LIMITS

I have a few suggestions for consideration. They are not meant to be exhaustive; many other proposals have merit and deserve to be considered. Here is my list:

- o First, the Government needs to reconsider the double taxation of dividends, a prime reason why debt is preferred to equity by many companies.

  Other countries have faced this problem and have developed reasonable compromises to eliminate or greatly reduce the imbalance in tax treatment. It is time our Government did so as well.

- o Second, there needs to be a review of capital gains taxation. Modifications ought to be made to raise the tax rate on short-term gains and eliminate it, or lower it substantially, for various classes of longer term gains.

- o Third, the capital requirements of financial institutions providing the financing for these deals should be scrutinized more closely. Any system of risk-based capital standards ought to treat especially strictly deals that involve huge quantities of debt and that depend heavily on locating eager buyers to purchase the subsidiaries the borrowing company intends to spin off to help repay the bank loans.

- o Fourth, beyond the formal application of impersonal numerical ratios, the central bank ought to be involved at the personal level with bank management, playing a leadership role in pressing for a return to conservative banking principles which are all too often neglected in the quest for quick profits. To take one practical illustration, that should involve insisting that syndicators of LBO loans accept a continuing responsibility toward the institutions to which they sell loans, even if a deal goes sour.

- Fifth, it is questionable whether any Government-insured deposits should be allowed to be invested in these loans or in the junk bonds that are then issued to retire them. If banks and thrifts choose to participate, let it be in separate affiliates not funded by insured deposits.

- Sixth, securities firms should not be allowed to underwrite securities for firms in which they have a direct stake themselves, whether an equity stake or a bridge loan. Disclosure of such positions is insufficient as a check on potential abuses. How can an investment banking firm do objective due diligence for the securities to be distributed to the public when the proceeds of the offering will pay off the bridge loan lodged in the securities firms' own holdings?

- Seventh, bondholders in the existing securities of the firm should be given an explicit legal right to sue the organizers of an LBO or other corporate decapitalization for damages ensuing from the resulting downgrading of the credit ratings of those bonds caused by that restructuring.

- Eighth, whenever the management of a company makes a bid for its company, there should be an immediate enquiry as to whether the group is utilizing inside information not disclosed to shareholders. Plus, a written explanation should be published why the business plan that the group intends to adopt after the LBO cannot be pursued as a publicly held company.

- Ninth, sufficient time, perhaps 90 days, should be provided for other bidders to compete whenever members of existing management propose an LBO.

- Tenth, I do not favor measures that directly limit the participation of the foreign institutional lenders who have been extremely important in the financing of many merger transactions. Some restraint, however, should be exercised by them. Regulatory authorities of the U.S. and other major countries have already made progress in developing uniform capital standards for banks. It would make sense to extend these efforts to include explicitly the treatment of merger financing. Moreover, I doubt that any major industrial country would want to be identified as a prominent source of funds facilitating the decapitalization of American enterprises. A continuing dialogue on this matter between U.S. and foreign officials will go a long way in harmonizing lending practices in this area.

CONCLUSION

These are just a few of the kinds of measures that should be considered. The basic thrust is that the current system of tax rules and financial regulation sets up a set of incentives and motivations which virtually ordain that the M&A, LBO craze will continue until it threatens the financial condition of the entire corporate sector. At that point, the debt-burdened companies will end up on the Government's doorstep, pleading for special assistance. And the Government will be hard pressed to say no. That is not the kind of free enterprise system we ought to have, one that speaks rhetorically of market disciplines but whispers in the closet that the Government will always bail people out if anything really nasty happens. But it is the kind of system we will end up with if nothing is done to introduce a more prudent regard for corporate capital than has been the case lately.

Chairman **Rostenkowski**. Thank you, Dr. Kaufman.

Doctor, you have stated that it is questionable whether any Government-insured deposits should be allowed to be invested in these transactions or in certain junk bonds.

This committee has an important responsibility, Dr. Kaufman, in this area, and later this month we will be holding hearings on the economic and tax issues raised in the current savings and loan crisis.

Could you explain how significant a problem you think these bank and thrift investments are and share with us any legislative proposal in depth that you might have or would have us consider?

Mr. **Kaufman**. At the present time, our financial institutions are so structured to maximize their assets, to maximize the growth of their liabilities, partly because the regulatory process has limited control over the credit quality in the activities of these institutions. FDIC insurance, FSLIC insurance encourages the raising of guaranteed funds at low cost—low cost because of governmental insurance—and reinvesting those funds in very high-yield assets and making the spread and leveraging the institution.

This has been one of the sad aftermaths of the legislation of the 1930's, particularly as the financial system has become more deregulated, and Regulation Q has been amended and virtually completely done away with. Over recent years, this has encouraged a wider form of asset allocation by deposit institutions in various forms: in mortgage securities, in LDC obligations in junk bonds, and in a variety of investments and lending where yields are high, against a low-cost Government deposit.

Now, the credit quality of a banking institution is really there because of the guarantee that has been issued by the Federal Government. When any of us today chooses a bank or a thrift institution where we place our funds, what induces us in that institution are usually two factors. One, nearness of the location; and, two, that there is a guarantee. And we discriminate as individual depositors very, very little.

Therefore, where is the discipline over this kind of activity? Unfortunately, the regulators themselves have lagged in exerting discipline, in acquiring an intimate knowledge of an institution, and in becoming involved with the institution before the trouble has become so deep-seated a problem that it cannot be neglected.

But it is very important that Congress, as it finds a solution to the FSLIC problem, also place a series of regulations and procedures to prevent a recurrence of this problem in the future. Nothing so far that I have seen really would suggest that this has yet been formulated.

I would strongly urge that those deposit institutions who do want to invest in high-yield assets, in assets that are not of the best credit quality, be allowed to do so, but in a separate affiliate where it clearly states that its liabilities are not an insured deposit.

Government insurance requires a responsibility. When the Government extends its credit to a deposit institution, the Government should also have the right to limit or to restrict the asset activity of that institution and to have it conform to a series of reasonable standards. This has not yet been put in place, and I believe it ought to be put in place as we go ahead.

Chairman **Rostenkowski**. Thank you, Doctor.

Representative Archer will inquire.

Mr. **Archer**. Dr. Kaufman, I have been fascinated by your testimony, and I think you have appropriately dubbed it a program of prudent limits. I notice that you did not say anything in your list of suggestions about restricting the deductibility of interest. I would be curious as to your feelings should the committee move in that direction.

Mr. **Kaufman**. The reason I did not mention anything about the deductibility of interest, Mr. Archer, is because this is a very complex solution, and formulating it is extremely complex. There are certain mergers and there are some leverage buyouts that ought to occur.

At the same time, to apply standards of interest rate deductions for utility companies, for automobile companies, for different industries that have different capital requirements and debt requirements, really requires a detailed intervention by the Government that can be quite difficult and, I believe, quite cumbersome.

I strongly believe on the other side, that we ought to eliminate the taxation on the dividends, and we ought to put into place stricter, more prudent rules of lending and investing, particularly by deposit institutions and others; and that we ought to hold regulators and the central bank much more responsible for their supervisory responsibility than we have up to now, when we ought to prescribe in much greater detail what those responsibilities ought to be.

Mr. **Archer**. I commend you on your testimony. Thank you very much.

Chairman **Rostenkowski**. Mr. Pickle will inquire.

Mr. **Pickle**. Dr. Kaufman, your testimony means a great deal to all of us, and I appreciate your comments. I think what you have given us is extremely worthwhile.

I want to make an observation. You have said that the issuance of these LBO loans or junk bonds would not make us competitive, it would weaken our competitiveness. Yesterday we had testimony just the contrary, that we needed the junk bonds in order to be competitive. I am glad that you have voiced your concern that that is not so, and that it really weakens us because it limits our investment capabilities in the industries and businesses we ought to be entering into.

Now, I was going to ask the same question as Mr. Archer, because you gave us some very good suggestions. You suggested doing away with double taxation of dividends, and that is desirable and we need to find a better answer for that problem. But if we did it, as you said, that would cost our Treasury somewhere in the neighborhood of $50 to $60 billion. Now, we cannot afford to make a dent in our balance sheets like that now.

Your other suggestions should make a savings. Would they make a savings equal to that amount required to make dividends deductible? Your suggestions are good. They involve a lot of regulations and intense scrutiny, but I do not know that those would save us that much revenue. How do we balance off the dividend deduction with your other suggestions?

Mr. **Kaufman**. Let me address two aspects which you referred to, Mr. Pickle. First is that there has been some testimony that debt makes us more competitive. I believe you cannot deny the dictum that equity allows a management much greater risk taking, much greater freedom of action, allows it to do much more long-term planning than when a corporate entity is heavily loaded with debt. I think that issue cannot be denied in the long run. And as we load up with debt, it will generate much more of a near-term focus by the American corporation than at any time in the post-war period.

Now, you ask, How can we make up the loss of revenue if we eliminate the double taxation on dividends and change the capital gains tax? In the current structure, if this would reduce the volume of debt financing and interest on debt is taxable, you would gain some revenue on that side, because corporate income, therefore, would be higher.

Let me just go through a simple exercise with you. Let us assume in recent years, in the last five years or so, that there was $400 billion of high-yield financing and debt financing through mergers, consolidations, leverage buyouts. And let us just assume the interest on that debt was ten percent, which is $40 billion. Let us assume further that on the $40 billion, the marginal tax rate is 30 percent for a corporation. That is $12 billion lost a year in income to the Federal Treasury. That is a loss that is an ongoing loss as long as that debt is outstanding.

Now, you could say, But there are offsets because there were capital gains taken. But some of the capital gains that are taken in these deals are by institutions that do not pay taxes, such as pension funds, State and local retirement funds. And that is a one-time situation. So I believe that if you could slow the volume of debt financing and increase the volume of equity financing, you would make up some revenue to the U.S. Treasury.

Mr. PICKLE. Well, wouldn't you slow the debt financing if you just reduced or eliminated the interest deduction?

Dr. KAUFMAN. Yes, you would.

Mr. PICKLE. That would slow it down quickly, wouldn't it?

Mr. KAUFMAN. Yes, you would, Mr. Pickle. I am not really opposed to that, but I do not have in my own mind a clear concept of how you implement it.

Mr. PICKLE. Let me make one other observation. You said that we ought to have a stricter scrutiny of some of these syndicators, these financial institutions that are providing it. I assume you have reference to big outfits like the KKR. How are we going to do that? They are big promoters, and they are not trying to get production. They are just trying to get control, and maybe they would make a lot of money. And there is nothing wrong with that. But how do you "scrutinize"?

Mr. KAUFMAN. Well, I think you scrutinize the source of their funds, and the source of their funds are a variety of institutions that participate in the financing. Leverage buyout companies themselves do have limited resources. They have access to financial institutions of all types, in the United States especially and to some extent abroad. It is there where prudent rules have to be applied.

If you apply prudent rules for those institutions, deposit institutions and others, I think you limit the activities of some of these companies.

Chairman ROSTENKOWSKI. Mr. Downey.

Mr. DOWNEY. Thank you, Mr. Chairman.

Dr. Kaufman, thank you for your testimony. I am intrigued by the last of your seven reasons why you felt that there was something seriously wrong with the amount of leveraged buyouts going on in this country. You said that somehow there is something insidious about finance and enterprise being locked together, and that this would inevitably lead to greater Government involvement. Then you mentioned that the case is true in Europe and Japan.

Could you elaborate on this? Because it does not appear to be hurting the Japanese.

Mr. KAUFMAN. Well, I believe as this kind of financing continues, the creditors that are going to be involved in corporations will be bigger, and corporations will be bigger debtors. As this takes place, the financial institutions that are the creditors have to pay much, much closer attention to the corporations to whom they have loaned money or invested funds in.

That means over a period of time the financial institutions will be involved in appointing the chairman, the chief executive officer of a business corporation, and will be having substantial influence on the election of board members to that particular corporation or series of corporations. This is an involvement that has never been indigenous to the United States, at all, because we have had over long periods of history a kind of separation between industry and finance. That has served us well because then both can apply certain disciplines.

When, however, you get the two more intimate, as is the case, for example, in Continental Europe in a number of key countries—Germany, for example—you will find that key financial institutions play a very, very important role in the management of business corporations.

This results in a further concentration of financial power and a further concentration of economic and industrial power. And as that concentration takes place, it becomes very difficult for the Government to remain outside of that loop, and it will have to intervene and not let the market process work.

So the very issue that is at stake here—letting the market process work—if we allow this to continue in the long run is going to lead to economic and financial concentration and the market then will not be allowed to work, unless Government intervenes.

Mr. DOWNEY. You mentioned the fact that it is the case in Europe, and you cited the example of Germany. It appears also to be the case in Japan.

Mr. KAUFMAN. Yes.

Mr. DOWNEY. Again, how is it hurting them vis-a-vis the United States? How are the Japanese hurt and the Germans hurt by this scheme in the area of international competitiveness?

I mean, one might make the argument, possibly, that this sort of concentration of power is more effective in terms of securing finance quickly and having a further check on maybe a less imaginative board of directors.

Mr. KAUFMAN. Not entirely, because if you examine the entire venture capital field in the United States, which blossomed over the last 10 to 12 years, and the growth of smaller enterprises as a result of venture capital firms forming and investing equity money in a whole series of companies on the west coast or along Boston or along Austin—in many of these places, that kind of activity has not taken place in Europe, and it did not take place in Japan, largely because these very large institutions do not have the entrepreneurial facility for it, do not have the facility to encourage it. This will be missed in the United States over a period of time.

Also, the independence of actions by people in the business and financial sector in the long run leads to increased efficiency. I do not believe that we, as Americans, want an interlocking Government with business and financial institutions that is highly concentrated in power. That I think is the ultimate risk.

Mr. Downey. What about the argument that some people make that the Japanese, the Government, the financiers, the corporations, are able to target enterprises that had been successful in our country—computer chip manufacturing, for instance—and, as a result of the concentration of this power, be able to create more market share as a result of intense focus and the availability of capital?

Mr. Kaufman. I think part of that is due to the growth of financial strength and economic strength of Japan. Part of that relates to the fact that we have a trade deficit and a current account deficit. They have substantial financial resources that need to be redeployed, and they should have the right to redeploy that. If we limit their activity here to any extent, it will certainly contribute to a substantial decline in the value of the dollar.

The fact is that over a longer period of time, looking out in the next 10 to 15 years, we will live in a more interdependent financial and economic world. The need is that there be established more of a level playing field, and the hope is that this Government will work hard with Japan and with Europe to establish a level playing field in business and in finance.

Mr. Downey. Thank you, Doctor.

Chairman Rostenkowski. Mr. Schulze.

Mr. Schulze. Thank you, Mr. Chairman.

Thank you, Dr. Kaufman, for your presentation. You stated that in the likelihood of an economic downturn, this would exacerbate the problems. Can you be a little more definitive? What kind of increased unemployment or problems or defaults or even bankruptcies do you see as a result of this excessive debt or the LBO's?

Mr. Kaufman. Well, there need not be the next time a deep recession. There need not be. But, certainly, heavy indebtedness by corporations is going to result in pre-empting cash flow of those corporations to meet interest payment and maturing debt. Therefore, those corporations are either going to have losses, which will be reflected in much lower stock prices than would otherwise occur; therefore, financial wealth of business, households and institutions will decline. And at the same time, these corporations will be far more inhibited in their business practices when it comes to inventories or capital spending than if they would be in circumstances of greater financial strength.

We already have that problem. We have also at the same time a problem of some of our deposit institutions being financially weak. We have at the same time the problem of some of our banking institutions still having a significant volume of loans outstanding to developing countries that are very marginal. Therefore, they are marginal borrowers outside the United States.

Under these circumstances, if we go into a recession any time in the next few years—2, 3 years, let us say—the chances are that our Federal Government cannot quickly come to the aid of this recession because we will enter that recession with still a relatively high budget deficit. It would be very difficult for any Government to then rush out and say we have to enlarge that budget deficit very quickly to fight a recession.

Thus, it is going to be incumbent on the central bank to respond very quickly to this potential danger, and it will have to move with great alacrity to lower interest rates and to inject a huge volume of liquidity into the financial system and take that risk, whatever that will do to the financial system as well as to the value of the dollar and our relationship with foreigners.

Mr. SCHULZE. So, in your opinion, this increased debt has created more marginally strong business entities?

Mr. KAUFMAN. It has contributed to more marginal businesses. We are now in the 7th year or 8th year in which more credit ratings of corporations are going down than up. And all of this is occurring in a period of economic expansion. You expect this typically to occur in a period of economic slow down. At the same time, as I indicated earlier, the financial strength of corporations in Europe is improving very significantly as well as in Japan.

Mr. SCHULZE. There seems to be a feeling—and it was expressed a little bit yesterday—that the number of LBO's may have even leveled off and may decline of its own weight. Do you want to address that area?

Mr. KAUFMAN. I believe this availability of funds and this type of financing depends on several considerations: One, on the level of equity prices; two, and very importantly, on cash flow of these corporations; and, three, most importantly, on the availability of credit. And as long as there is substantial availability of credit to do such deals, the deals will be done because the immediate profit margin or the profitability to hold a series of participants in this is very strong.

I believe it is very hard for market participants in this kind of an endeavor to really police themselves. As I indicated in my statement, management of these corporations, if they are involved, have options that are substantially increased in value. The fact is the stock market goes up in price, and there is immediate gratification. Lawyers have substantial fees. Bankers have substantial fees.

It is very hard to control this unless there is some limitation in credit. If we go into a period of much higher interest rates, that will eventually check some of this activity. But without a decline in credit availability, which is still good, I think we will see ongoing activity in this kind of financing.

Mr. SCHULZE. Dr. Kaufman, the bottom line of this is that somebody has to play God, or else we have got to let the market do it. Who would you pick, or how do we resolve it?

Mr. KAUFMAN. That is a very good point, Mr. Schulze. Let me respond to this.

I am all in favor of letting the market do it, but we ought to understand what that requires. It requires that those who do well prosper, and those who do poorly fail.

Now, are we willing in our system to let financial institutions fail? Are we willing to let major business entities fail? The history over the last 10, 15 years has not demonstrated that. That would be clearing the market and starting off new, and that was part of our history in the 19th century. We had failures in railroads and banks and business corporations, and we revitalized ourselves. That has not been the history of the last 20 to 30 years in the United States.

Now, if we are unwilling to let the market do it in this way, then some measure of surveillance and regulation has to be put in place.

Now, I understand there are others who testify and say there are no perfect solutions. But at the same time, if we let the process continue, there is a transformation that will take place in the financial and economic markets over a period of time that will change our structure very substantially, and then we cannot put Humpty-Dumpty back together again.

Mr. **SCHULZE**. Thank you.

Thank you, Mr. Chairman.

Chairman **ROSTENKOWSKI**. Mr. Pease will inquire.

Mr. **PEASE**. Thank you very much, Mr. Chairman.

Dr. Kaufman, thank you for being with us. I think you make an extremely valuable contribution to our discussion.

Could you help me to understand what it is that has caused the great shift from equity financing to debt financing in the last 8 years? Is it something that Congress did or failed to do, or are there some market forces involved?

Mr. **KAUFMAN**. Well, there are a whole series of developments that have contributed to this. Our tax structure is just one contributing factor.

No. 2, we have deregulated financial institutions and financial practices, without putting into place new rules of conduct.

No. 3, the generation of Americans that lived through a period of economic and financial travail is diminishing. And over a period of time, there now is in power a new generation that has only read about this, and sometimes not read about what has happened in periods of financial travail.

Indeed, I would say to you as an aside, if you checked with most of the business schools in the United States, hardly any offer a course in financial history of the United States, or the history of financial institutions and markets. To many graduates, their financial history begins the day they enter the business stream.

Beyond this, I think it is important to recognize the risk taking has increased because we have gone through a period of the last 20 to 30 years where most have survived. Now, we had a credit crunch in 1966, which brought to the brink some thrift institutions at that time, but they survived. We had a failure of Penn Central in 1970, and most survived. We had the 1974–75 problem of New York City and Franklin National Bank, and most survived. And we have had the problem of Continental in 1982 and so on, in the early 1980's a variety of financial institutions, Penn Square, and most have survived.

As a result, that has encouraged those who have survived to look back and say, well, the period of stringency and the period of travail were short; and, therefore, to take added risk maybe is something that ought to be encouraged by us rather than prudence. And we have survived it because we infused a lot of liquidity and we allowed the credit or debt expansion to continue. So we have stretched the system, and there are a series of factors that have contributed to this.

Mr. PEASE. Thank you very much. That is, indeed, helpful.

Yesterday, Secretary Brady appeared before us, and with great repetition—about eight or ten times, by my count—suggested that the one and only solution that he would recommend is to eliminate double taxation of dividends. And he suggested in response to a direct question from me that that would level the playing field; and if we eliminated double taxation of dividends, the trend would be ended because equity would be every bit as attractive as debt financing, and we would not have to worry any more about these highly leveraged financial deals.

If we assume that your recommendation would be adopted, and we were somehow to eliminate the double taxation of dividends, do you think that would create a level playing field so that equity financing would be equally attractive and equally employed in these big deals?

Mr. KAUFMAN. Well, I believe it would significantly help. At the same time, as you know from my recommendation, I also suggest that Congress go beyond this; that regulators, supervisors of official institutions dealing with the financial market ought to be given much stricter responsibilities of looking at the conduct of financial market participants and putting forth a series of standards which do not prevail at the present time.

Since markets are now global, I think our regulators of official institutions ought to be involved in very serious dialog, to coordinate policies on these matters internationally. Changing the double taxation on dividends and capital gains tax are worthwhile recommendations, but I think they ought to be supplemented very significantly with other suggestions.

Mr. PEASE. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Coyne will inquire.

Mr. COYNE. Thank you, Mr. Chairman.

Dr. Kaufman, at one point, you had advocated the creation of a national board of overseers of financial institutions.

Mr. KAUFMAN. Right.

Mr. COYNE. I wonder if you could explain what the board's function would be, and, more importantly, would the board have any regulatory role in the area of takeovers?

Mr. KAUFMAN. That is right, Mr. Coyne. I still would favor a board of overseers over financial institutions and markets, for a variety of reasons. Years ago, our financial system was very segmented, and we had institutions that catered to local markets, regional markets, institutions that were prohibited from engaging in a wide-ranging series of activities. That all is being diminished because we have deregulated, technology has improved enormously, the ability to transact business financially, globally and within the United States has shifted. We have gradually moved to national and international money and capital markets, and a variety of institutions operate in that new environment.

We have a whole series of different regulators and supervisors with responsibilities over these institutions. Some even compete with each other rather than fully coordinate, necessarily, with each other. There should be, as a result of this structural change in our financial system, a board of overseers. Perhaps the Federal Reserve ought to play a central role in this and look at our financial institutions and our financial markets in an integrated way, not in a segmented way: Here are stocks and here are bonds and here are thrift institutions and here are commercial banks. They all operate more or less on the basis of handling temporary funds and handling permanent savings.

I would strongly continue to recommend the formation of that kind of a board of overseers, and that board of overseers, I think, would have to come to grips with the issue of this kind of financing because it transcends the junk bond market just because S&L's might invest there. There are other institutions that invest in junk bonds. It transcends the thrift institutions because financial markets in a trading sense are involved.

That is why I believe eventually we will move in that direction when some of the vested interests recognize it is not to the best interest of the United States.

Mr. COYNE. So the board could perform a useful function in the case of takeovers?

Mr. KAUFMAN. Absolutely.

Mr. COYNE. Thank you.

Chairman ROSTENKOWSKI. Mr. Sundquist.

Mr. SUNDQUIST. Thank you, Mr. Chairman.

Mr. Kaufman, I appreciate your testimony. I have a quick question, and it relates to pension funds. Do you see any trends and dangers in the use of pension funds in LBO's?

Mr. KAUFMAN. So far, as far as I can tell, from the pension funds that I have spoken to and seen their portfolios, I do not. They still are investing only a very small percentage of their total assets in this kind of activity.

Also, from a broader viewpoint, from an analytical viewpoint, it seems to me that pension funds have the kind of liability that lends itself to somewhat greater risktaking, as compared with deposit institutions which perform a great liquidity function.

It is pension funds that do put more of their funds in equity than other institutions, and perhaps rightfully so, because of the longer-dated nature of the liabilities which they have.

Also, I think when you analyze a high-yield bond, there really is inherent in that obligation two elements: There is a portion of it that is a bond, and there is a portion of it that is really equity. Legally, we still call it a bond.

Now, I think the pension fund is in a better position than most other institutions to take that risk, if it does it in moderate form; more so, let us say, than thrift institutions, because thrift institutions have as their liability a deposit on which the institution is required to meet its obligations, perhaps at times very quickly, and thrifts and other deposit institutions are really part of a payments mechanism which the pension fund is not.

Mr. SUNDQUIST. Thank you, Dr. Kaufman.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman.

Dr. Kaufman, it is tempting to focus on your detailed proposed solutions or options, but let me resist that because I do not personally see Congress acting on any solution unless it is convinced there is a real problem. And the testimony yesterday, the part that I could hear of it, at least from the Secretary, downplayed the urgency of the problem.

I heard him saying there is an ailment, but it is much more like a common cold in its seriousness than pneumonia, that is for sure; that if we were taking the temperature with a regular thermometer, 98.6 being normal, I read his testimony as saying maybe the fever was 99 degrees. So do not move hastily.

In fact, he said a number of times the following: We have a habit of correcting things just as they are about to correct themselves. I do not think that there is any greater stimulus to prevent inaction—I cannot think of one, anyway.

Maybe he is right, but I just think we need to know whether other people with expertise think that is a correct analysis or it is not. So let me ask you, because I do not glean from your testimony your feeling about the degree of urgency. If you were sitting here instead of there—it may be hard for you to contemplate, but if you were here instead of where you are, would you act this session?

Mr. KAUFMAN. If I were in your position, which is a difficult one to be in, I would, based on my recommendations, certainly act, for several reasons that I tried to state.

One is that somewhere in the next 3, 4 years we will be in a recession. That recession will become more difficult to deal with as this situation continues. But even more importantly, I think what Congress has to recognize, as this continues to go on, you will not have the opportunity to restructure what has taken place.

What will take place over the next 4, 5, 6, 7, 8 years, is a pathological change in our financial and in our industrial sector, a change in which debt becomes more important, a change in which financial institutions become more important in the decisionmaking of business corporations, a closer intimacy between those two, and a higher concentration of financial and business assets. And that will ultimately draw the Government in when serious problems occur.

Now, that is the issue, whether Congress really wants to perceive the process that is now in place in the United States, changing what has been in place for such a long period of time, a division between business and financial markets. And what you are willing to accept by not acting is that you are willing to have an intimate relationship between financial institutions and business corporations, between financial institutions that are supposed to be fiduciaries on the one hand, and business corporations which are supposed to be the risk-takers.

Mr. LEVIN. And how dangerous, just use an adjective that—you will not overstate it, anyway. But give us a sense of the degree of urgency.

Mr. KAUFMAN. I think there is a very high degree of urgency based on the near-term consideration that I stated, and, even more important, about the transformation that is in process here—which, if you do nothing, you accept it. You accept it, and I believe as long as there is continued substantial availability of credit, the process will continue.

Mr. LEVIN. Thank you.

Chairman ROSTENKOWSKI. Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Chairman. Thank you, Dr. Kaufman.

I just want to take 1 minute for some clarification on your point 5, where you say Government-insured deposits should not be allowed to be invested in these loans. I am not quite clear on this point, Dr. Kaufman. We should talk about pensions which are a concern of mine. Would pension funds that are guaranteed by the PBGC be restricted?

Mr. KAUFMAN. No; it would not. The primary reason for my conclusion is that I believe that pension funds, having long-dated liabilities, can assume somewhat greater risk than deposit institutions that have short-dated liabilities. Naturally, if this were to become an overwhelming portion of their total assets, that would eventually pose a problem. But I do not see that at the present time.

It is the nature of the liability that encourages me to say that pension funds ought to have greater flexibility than some other institutions.

Mrs. KENNELLY. Dr. Kaufman, we had Kathleen Utgoff, of the PBGC in front of us yesterday, and she did not seem concerned about this situation.

Mr. KAUFMAN. Right.

Mrs. KENNELLY. Let me ask you: Shouldn't we have some concern if we saw pension funds going from 1 percent, say, up to 10 percent? Should we then be concerned?

Mr. KAUFMAN. Even if 10 percent were in these high yielding obligations in general, not speaking about any particular pension fund itself, but in the aggregate I would believe that would not pose a problem, because of the long-term nature of the liability, and because what you are really dealing with is a partial equity investment and a bond investment.

And I suspect, within ~~a relativel~~y short period of time, most pension fund investors will, in their own mind, make that determination when they take down this particular issue, or whatever it is, and say, well, we are really buying so much of equity and so much of bond.

Mrs. KENNELLY. Thank you, Mr. Kaufman.

Chairman ROSTENKOWSKI. Mr. Brown will inquire.

Mr. BROWN. Thank you, Mr. Chairman.

Dr. Kaufman, we appreciate your coming, and have found your responses and your testimony most helpful.

I am intrigued with the statement that you made earlier in response to Mr. Pease's question, which related to why this phenomenon has occurred.

What our committee's reports indicate is confirmed by your testimony of a substantial increase in payouts of corporate equity and a substantial increase in net borrowing. In that regard, you've given us better testimony, I think, than any of our previous witnesses in listing why there was a tendency for this phenomenon to occur.

The reports we have, though, indicate this changed dramatically in 1984 and in the years following so that you had an enormous surge in 1984 in reductions of corporate equity and increases of borrowings. And that phenomenon seemed to follow thereon.

The point that intrigues me is that all the reasons that you listed and all the reasons that our previous witnesses have listed for this phenomenon occurring do not coincide with this enormous surge in 1984. The tax changes occurred before 1984 and the same with some of the other factors.

Is there any additional factor that occurs to you that seemed to coincide with this surge in the payout of corporate equity that we haven't talked about?

Mr. KAUFMAN. You may recall in 1984, in the first half of the year, interest rates were very high, and it was in the second half of the year that interest rates in the United States started to decline quite significantly.

We had long-term U.S. Government bonds, in May or June of that year, as high as 14 percent. And those bond issues then went down in yield sometime a year or so ago to around 7 percent. So we had a very sharp decline in interest rates, and a very significant increase in credit availability. That certainly contributed, at least partly, to the surge.

Also, of course, this was the period in which innovative financing proliferated in the financial community. There were a whole series of new instruments, options and futures, and interest rate swaps and currency swaps and all kinds of financing techniques that were brought through the floor because of the competitive nature within the market and the new technology. All of that, I think, was a further propelling force to be creative in this area.

Mr. BROWN. That's very helpful.

I noticed that the sixth point in your recommendations involves a suggestion that security firms not be allowed to underwrite stocks in which they have an equity interest themselves.

My recollection, though, is that these firms, when they do an underwriting, if they're not doing a best effort underwriting, end up making a commitment to sell or acquire themselves all of the stock in the underwriting. So that they, by the very nature of the underwriting, have a vested interest in the sale of the stock.

Mr. KAUFMAN. That I don't question. I do question the ability of a security firm or, for that matter, a commercial bank that will ultimately do this, to have on its books a bridge loan, a loan that is really to bridge the gap as a temporary piece of financing where the corporation gets money and is paid off by a public offering or a private placement within the financial markets.

It is very difficult under those circumstances when that kind of an accommodation has been made by a security firm or by a commercial bank to then say that it has done objective due diligence on behalf of the future investor in the obligation that's being offered. There is a clear conflict of interest, since the bridge loan will only be paid off if the securities are sold

Mr. Brown. Well, I find that a very valid and persuasive point, that there is indeed a conflict of interest there and that it should be avoided.

My question is, isn't that conflict of interest present in an underwriting agreement by its very nature?

Mr. Kaufman. Well, not entirely. In the more traditional underwriting, it is true an investment house or a bank goes out, examines the entity, and will make a commitment to place that issue and give a check to the borrower or to the equity issuing corporation for the proceeds before they are distributed and fully sold.

That is a different kind of commitment than when that investment bank already has on its books a whole series of obligations that must be paid.

Mr. Brown. Oh, I see. Their due diligence, their review, takes place before the commitment and not after?

Mr. Kaufman. That's correct.

Mr. Brown. Thank you.

Chairman Rostenkowski. Mr. Moody will inquire.

Mr. Moody. Thank you.

Thank you, Mr. Kaufman. I think that your nine points are extremely helpful, and I find myself in agreement with them.

Let me ask you about two that I have some questions about. One in particular is the double taxation of dividends.

If we suspend the double taxation of dividends, we would confer an enormous windfall gain to the owners of corporate stock. I guess the revenue loss is in the $20 to $30 billion range, because I suppose it is in pretty close approximation to the windfall gain we would be providing. That obviously would go to predominantly upper income people, at least a large share of it that would. I don't know the exact incidence of ownership accorded to stock, but it certainly is held by above average income people.

How could we justify making the Tax Code more regressive?

Mr. Kaufman. First of all, I suggested on the capital gains tax that we continue to have a substantial capital gains tax on capital gains that are taken, let's say, within 1 year, and have no capital gains tax over 1 year.

I think the offset, in terms of the revenue comes from the other side. If you don't do anything, we continue to have a lot of debt financing. Debt financing interest payments reduces earnings. The reduction of earnings reduces tax payments.

Mr. Moody. Well, I agree with you on the revenue. I am only looking at the progressivity issue for the moment.

Mr. Kaufman. Well, there is another feature here in this, and that we bemoan in the United States the low rate of savings. This is one way to encourage some additional savings and some additional investment.

Mr. Moody. Let me move then to your second point about capital gains.

Are you suggesting that we raise the tax on short-term capital gains above the current income tax level?

Mr. Kaufman. Yes. Yes.

Mr. Moody. So you would not set it equal to the income tax level with a deduction tax cut for long-term gains. Instead, you would leave the long-term capital gains as it is, and you would raise the short-term rates, or would you spread it so that short-term capital gains would tax higher than current income, and long-term capital gains tax lower than current income?

Mr. **Kaufman**. My preference would be to raise the short term above the current tax rate.

Mr. **Moody**. Above 28 percent.

Mr. **Kaufman**. Above. And, at the same time, eliminate the long-term capital gains tax altogether.

Mr. **Moody**. Make it tax free?

Mr. **Kaufman**. Tax free.

Mr. **Moody**. What would your cutoff be, 1 year you mentioned in your testimony?

Mr. **Kaufman**. Probably 1 year.

Mr. **Moody**. Mr. Kaufman, wouldn't it make more sense for us to simply index the basis of capital gains incomes as Treasury 1 suggested a few years ago so that you don't have this notch, a sudden effect of what you pass in 365 days?

Mr. **Kaufman**. Indexation to inflation, is that?

Mr. **Moody**. Right. I mean to index the bases so that you do not penalize people who make it just slightly less than the capital gains cutoff, rather the penalty decreases gradually and continuously the longer you hold the stock, or conversely increases the shorter you hold it on a continuous base rather than this sudden notch effect?

Mr. **Kaufman**. Well, I have a philosophical problem with indexation. I believe there should be no indexation. We should protect no one against the ravages of inflation. We should have a Government policy that prevents inflation. And indexation allows inflation to proceed.

I think the political will to fight inflation would be far greater if we didn't have indexation. So, from a philosophical viewpoint, I really oppose all kind of indexation.

Mr. **Moody**. We've already indexed probably 60 percent of the budget on the spending side.

Mr. **Kaufman**. I know.

Mr. **Moody**. And virtually all of it on the revenue side.

Mr. **Kaufman**. You're right. But I think it is not the right way to go. There is a lot of indexation in some high inflation countries, and it really has not prevented problems, it's exacerbated the problems.

Mr. **Moody**. So you would apply the pain theory of restraining inflation, let it hurt more.

Mr. **Kaufman**. That is correct.

Mr. **Moody**. I see.

But I do think that the other points, particularly the ones about not allowing those who have a direct stake to handle these matters.

Your No. 7 point is the explicit legal right to sue the organizers of an LBO, or other corporate decapitalization for damages in suing. Don't the more sophisticated holders of bonds already write those covenants into the bonds?

Mr. **Kaufman**. There have been some recent issues that have come to market which attempt to protect the bond holder from this kind of a decline in credit rating. But many issues still come without that kind of protection.

Mr. **Moody**. But won't the market solve that in the sense that now everyone is alert to the problem, bonds that include those covenants will sell at a higher premium relative to those that glaringly omit to include those covenants?

Mr. **Kaufman**. Over the long run, I believe that is right. However, it may very well be that corporations who are involved in this kind of activity or who contemplate being involved in this kind of activity may go much more into a banking institution to do their financing, to do adjustable rate financing which means that the interest rate fluctuates perhaps with the credit rating, or the interest rate fluctuates with open market rates. And in that sense, you change the nature of the financial system additionally.

Mr. **Moody**. Thank you.

Chairman **Rostenkowski**. Mr. Rangel will inquire.

Mr. **Rangel**. Thank you, Mr. Chairman.

Thank you so much for your testimony, Mr. Kaufman. I only wish you were here yesterday when the Secretary of Treasury was testifying.

Did you hear or read about the remarks he made in this area?

Mr. **Kaufman**. I just read the newspaper summary this morning coming here.

Mr. **Rangel**. One of the questions I asked him was what the revenue impact will be if we continue to subsidize these corporations with the interest deduction. And he told me that he didn't see any impact; that the capital gains taxes on the transfer and the sales of stock that would accelerate would wash out any loss.

And from your testimony, you are indicating that if this trend continues, not only is there a possible threat of financial disaster for our financial institutions, but you think that the corporate revenues would be sharply decreased. And I'm concerned about that because I also asked the Secretary his impression of our national deficit. And he had indicated that, while it was a priority with the Administration, that I should be reminded that it's a smaller part of our Gross National Product, and compared to the European ratio of debt, that there wasn't that much to worry about.

And it just seems to me that with the Secretary of Treasury not being concerned about these two trends this move from equity financing to debt financing, and the passing over of our national deficit, which concerns me the most when we deal with the budget, and we have to concern ourselves with the debt service expenses that are involved, in addition to the legacy that we leave to our children and our grandchildren, I just wonder whether you could share with the committee how you reached the conclusion that we would be losing a lot of revenues here, and what should my response have been to the Secretary when he told me that the stock transfers that are generated by these type of LBOs would wash out the loss in revenues as a result of the preferential treatment we give for debt financing?

Mr. **Kaufman**. Well, I believe that, over the intermediate and long term, there is a loss of revenue, as I suggested in my simple calculation earlier in the questioning.

Of those who enjoy capital gains on their holdings of a leverage buyout, where the stock goes up in value, some are not taxpaying institutions. Pension funds, State and local retirement funds, and so on, do not pay a capital gains tax. So a portion of that particular gain is not taxed.

Second, the moment that financing goes on the books, and as long as it stays on the books, that means interest payments are being deducted from corporate earnings, and decrease corporate earnings that are subject to tax payments.

Third, I think it has to be recognized that this is an inducement to a corporation to tend more toward debt financing than toward equity financing. And to the extent to which that is occurring, it does reduce corporate tax payments.

The cumulative effect over a 4- or 5-year period can be very, very substantial. And I strongly feel that this particular tax aspect does compel some corporations to do more debt financing than would take place otherwise. I think it is very difficult for anyone to prove that, over a 4- or 5-year period, that there is a washout. I think there is a net loss in revenues to the U.S. Treasury.

Mr. **Rangel**. Well, I thank you because I guess what you're saying is that this committee, besides our responsibility to correct anything that is not working the way we would want, could really look at this as a revenue raiser if, indeed, the administration decides that we should do more than read the President's lips; that this would be a proper item to be on our agenda to raise revenues.

Mr. **Kaufman**. I think the most important issue here, Mr. Rangel, is what is happening to the corporate community, to the fragility of the financial system, and to the long-term change that will materialize in finance and in business relationships. That is as critical, probably more critical than even the immediate Treasury loss which has to be important to you here in Congress dealing with the deficit.

Mr. **Rangel**. Thank you, Mr. Kaufman.

Chairman **Rostenkowski**. Mr. McGrath will inquire.

Mr. **McGrath**. Thank you, Mr. Chairman, and thank you, Mr. Kaufman, for your insightful testimony.

I bring you greeting from my constituent, Al Wojnilower, your buddy on Wall Street.

You gave us about 10 examples of things that may help in this situation. You characterized the use of debt financing, as did Secretary Brady, by the way, as perhaps a waste of our assets. Two of your suggestions would require us to change the tax law, one in capital gains and the other in taxation of dividends. And you gave us about eight others.

Given the deficit situation we find in ourselves today and the political climate that may exist on the committee regarding our ability to change or to create a differential capital gains rate or to do away with the double taxation of dividends, do you believe that the other eight suggestions, regulatory suggestions, might be helpful without the changes in the tax law?

Mr. **Kaufman**. I believe, Mr. McGrath, that they will help and certainly will go a long way. The taxation aspect, nevertheless, is quite important, and I don't deny its importance.

But if you give me 8 out of 10, I would say it goes a long way to solving some of these problems.

Mr. **McGrath**. Well, given the 10 as weighted 10 percent each, do the two items on the taxation then become 50 percent of the solution or is it a higher percent of the solution?

Mr. **Kaufman**. I think they're at least 30 to 40 percent of the solution.

Mr. **McGrath**. Thank you.

I would like to inquire, as Mr. Moody did, on your seventh recommendation that bondholders in existing security firms should be given the explicit right to sue.

Is this not the thrust of the suit, the Met Life Suit in the RJR/Nabisco takeover?

Mr. **Kaufman**. I believe that is in process. I do not know how that is going to come out. That may take a considerable period of time before there is any definitive ruling by the court.

I think, nevertheless, it is an issue that Congress ought to consider, and particularly if we don't have a ruling by the court in 2 to 3 years.

Mr. **McGrath**. I thank you for your testimony. Thank you.

Chairman **Rostenkowski**. Mr. Guarini.

Mr. **Guarini**. Thank you, Mr. Chairman.

Mr. Kaufman, I want to thank you for your wealth of experience and your practical approach. And it has been very, very helpful to the committee.

Let me ask you about the liability that you said should exist and a suit for damages could ensue if there is a downgrade of the credit rating on part of the bondholders.

Rather than to have a strike suit which would hold up deals, and lawyers, of course, would get involved in multi-million-dollar suits, would it be a better idea, or could you comment on having a floating cap on interest rates so that they would be so many points above prime? We used to have usury laws once upon a time in behalf of individuals.

But if a corporation is going to water down the equity, shouldn't there be a point of which he knows when he buys a share of stock that it's not going to be watered down past a certain point? Could you comment on a floating cap?

Mr. **Kaufman**. I believe in shares there is a different relationship than in a debt instrument, in a credit instrument. An equity share of common stock is a form of risk taking for better or for worse.

A creditor enters into a relationship with a debtor on an assumed set of contractual arrangements. One of those is based on the credit standing of that corporation, and that there is not going to be an event outside of normal business activity that will endanger that particular credit standing.

There is one way to eliminate that problem besides perhaps what you suggested, and that is that once this kind of financing is being contemplated, or activity is being contemplated, then perhaps all of the debt should be scheduled to mature and should be paid off at par if the creditor so wishes.

The creditor, on those circumstances, would be only modestly damaged, that he hasn't got the rate of return that was being promised for 20 or 30 years, but he has the option to get his money back.

Mr. GUARINI. So this would, in effect, stop some wild LBO's, at the same time protect the bondholders?

Mr. KAUFMAN. The bondholder who has a AA or an A-rated bond, or a AAA-rated bond, would then be protected because he would get out at par.

Mr. GUARINI. And it would also protect the stockholders.

Mr. KAUFMAN. And, in a sense, would require that a whole reschedule of financing would have to take place.

Mr. GUARINI. Let me ask you, if you have—one of the problems are the arbitrageurs. I assume that they are part of the equation.

If you had a short-term capital gains, that would get to that problem, wouldn't it, because they would say if they had to pay a 50-percent capital gains that they would be less likely to enter into the gain of trying to acquire a stock knowing or anticipating there is going to be an LBO?

Mr. KAUFMAN. Well, it would diminish the profitability if you have a high tax rate.

Mr. GUARINI. Would it stop the activity somewhat?

Mr. KAUFMAN. And it would lessen the activity.

Mr. GUARINI. Lessen it?

Mr. KAUFMAN. To that extent, yes.

Mr. GUARINI. So that would be another reason to have a short-term capital gains?

Mr. KAUFMAN. That is correct.

Mr. GUARINI. Dr. Feldstein, when he testified yesterday, talked about cash flow business tax, which was more or less what we consider expensing out; that there would be no depreciation schedules; that if a corporation made the money, they could write off all the automobiles and machinery or whatever it is, that particular year. And, of course, that would be a certain loss. It would be a large expense to the Government, but to offset that by not allowing the interest to be deductible on loans so that there would be a quid pro quo.

Could you comment on that, sir?

Mr. KAUFMAN. I have not studied Mr. Feldstein's proposal. I will look at it. And perhaps, if you want me to, I'll comment on it later.

Mr. GUARINI. Yes, I wish you would.

Mr. KAUFMAN. You could say, as a general proposition, I believe that institutions and corporations should have very conservative accounting standards and should be allowed to charge off things and have reserves. Because the stronger financial institutions or incorporations are, the stronger the economic base of the country is, and the more they are able to take risks and to be entrepreneurial.

Mr. GUARINI. And it would make us more trade competitive?

Mr. KAUFMAN. And make us much more competitive.

If you examine some of the accounting practices outside the United States, business institutions and financial institutions have much more leeway to be conservative in reserving and building up financial strength than organizations have in the United States.

Mr. GUARINI. And this would lead to helping the equity side of the equation?

Mr. KAUFMAN. That is correct.

Mr. GUARINI. Right. Thank you very much.

Chairman Rostenkowski. Mr. Gephardt will inquire.

Mr. Gephardt. Thank you, Mr. Chairman, and thank you, Mr. Kaufman, for being here.

Lane Kirkland is going to testify next, and attached to his statement is a list of jobs that he believes have been lost because of LBO's and takeovers and mergers. And I take it he means that he thinks they have been permanently lost in some sense.

In reading your four or five reasons that you think there are negatives to these outcomes, I don't see the job loss per se mentioned. You do talk about weakening our competitive position.

I would just like to ask if you believe that good paying American jobs are lost because of these takeovers and mergers that wouldn't be lost if we did something about them to slow them down?

Mr. Kaufman. To some extent, this may be true. I have not studied whether there have been jobs lost that were performing efficient services. That really is the critical underlying issue.

I do believe some of these transactions have been consummated for near-term financial purposes, and near-term financial gains and, in some instances, do not improve the efficiency of the business entity. All right. And to the extent to which this may be occurring, there could be job losses that should not have occurred.

But I have not evaluated the impact of this on job losses.

I must say, as I said earlier, I am not against mergers and consolidations. I think there ought to be more prudence when it comes to this rather than a clear-cut rule there shall not be mergers and consolidations. I think that would be wrong.

Mr. Gephardt. Don't you agree that one of the things that we need to look at in the public interest is whether or not it weakens us economically and loses us good paying jobs?

Mr. Kaufman. I believe that what Congress ought to be concerned with is that we should have a strong economic and financial system. And if we have a strong economic and financial system, we will have economic growth, we will have reasonable stability and business fluctuations that are within reasonable bounds.

I think the movement into the creation of more debt by the corporate sector will contribute to greater volatility in the economic world, greater volatility in the financial world, and will eventually transform the financial and economic system into a financial and industrial complex, and an intimacy between industry and finance that we in the United States have never experienced. And that will increasingly involve the Government and change the system that we have today.

Mr. Gephardt. Let me ask you a question about your remedies. Your first two have to do with the double tax on dividends and then on capital gains tax. And my question is if we decide not to do either of those, or substantially decide to do either of those, because of other side effects in other areas that those changes would cause, such as perhaps a loss in revenue because of the concern about the deficit, or because of just fairness, not wanting a concentration of wealth to be increased at the top; and if we did a lot of the other things that you talk about, that I take it are less broad in their application, would we have a good effect on slowing down some of these bad mergers and takeover attempts?

Mr. KAUFMAN. Mr. Gephardt, if you did the remaining eight and not the first two, I think that would still be very, very helpful in slowing down the process that is underway right now.

Mr. GEPHARDT. The last question has to do with international investment in the United States.

As I get it, in the RJR deal, Japanese investors were either involved, or were asked to be involved, and one of their questions was whether or not bonds could be denominated in yen rather than dollars.

I understand what you're saying in your last point, that we should not restrict foreign investment. But aren't you concerned that, because of the huge number of these deals, and the huge need for capital, and with foreign investors buying both bonds and becoming involved in equity, that it does jeopardize our competitive position in the long haul?

Mr. KAUFMAN. I think the solution to that problem is ultimately to reduce significantly our current account deficit, and secondly, to work very hard with our foreign allies to have a level playing field in both trade and in finance. And to have much greater coordination when it comes to investing and the financing in these fields.

Mr. GEPHARDT. Thank you very much, Mr. Chairman.

Chairman ROSTENKOWSKI. Mrs. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman.

Thank you, Mr. Kaufman, for your excellent testimony this morning on the complex causes of the situation we face, and on possible solutions.

In the area of solutions, I was very interested in your response to earlier questions as to the power of regulatory changes versus tax changes, to at least control what is happening. You also referred to the deregulation of the financial sector as one of the causes of this situation, that is deregulation without putting in place any new rules. What were the most important deregulatory actions in your mind causing this?

Mr. KAUFMAN. Well, a number of changes have occurred in the financial system on the deregulation side. One, of course, is financial institutions now can compete for deposits on an interest rate basis. And those deposits are insured. Financial institutions are allowed to make loans, and to make investments on the asset side in a wide ranging series of obligations, many different qualities, including marginal credit quality. That is a cross utilization of the financial system, where many institutions can go into the business of other institutions.

There are many foreign institutions that have come to the United States, and many American institutions have gone abroad. And so we are saying let the market competitive process work.

Now, I am all for that, but at the same time that means that those who do poorly must fail, and those who do well, prosper. And when it comes to that particular solution, we are unwilling to accept it, because the private savings and the public savings, when it comes to financial institutions, are at stake.

And therefore, since we do offer an implicit or an explicit guarantee on the liabilities of most major financial institutions of the United States, where the deposit institutions were otherwise, it would seem to me that we have to put in place, unless we want the market process to work, a series of rules and regulations urging prudence in the management of the financial assets of those institutions.

And we should have in place official regulators who are very keen in really enforcing those kind of prudential rules. I think this is where we have missed in the postwar period.

Mrs. JOHNSON. Thank you very much, Mr. Kaufman. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman.

Yesterday, Mr. Kaufman, Secretary Brady cautioned this committee not to act precipitously, and to continue to monitor this situation. I gather that you disagree with those observations.

Mr. KAUFMAN. Well, I believe Congress should consider a series of proposals, as I have outlined. Indeed, in looking back, and it is easy to look back, if we had raised questions of this nature 10 years ago, and 15 years ago, or even 6, 7 years ago, as it applied to deposit institutions, when these problems of deposit institutions were in their infancy, perhaps today we would not speaking about a $50 to $100 billion problem when it comes to our thrift institutions.

If we had talked about some of these issues, as to the changes that are taking place in our financial system, we would not be perhaps having to discuss the extent to which Governments will have to guarantee the obligations of the developing countries in order to have refinancing take place, and new lending take place in those countries.

There is a period in time that you have to get involved. When it becomes a very serious crisis, then the resolution to those problems are really helter-skelter, and probably not the best.

Go back to the 1930's, when we put into place deposit insurance as an explicit guarantee. It was considered certainly the right thing to do at the time. But what we failed to recognize at that time, and since, is that that kind of deposit insurance guarantees the liability of private institutions, and therefore means those who put money into those deposit institutions, are not really the creditors that monitor very closely what is going on in that institution any more.

So on the one hand, we enacted legislation without fully taking into consideration the ultimate aftermath of this. And I believe that we are at the stage right now, if you disregard what is going on, in 4 or 5 years from now the situation will be far more acute. Then you will have to take much more drastic action, just as what is occurring right now with the savings and loan associations.

Mr. ANDREWS. One of the suggestions that he did make yesterday in response to some of our questions was to cap the interest deduction in some manner, although he was not specific as to how this would happen. I wonder if you would comment on what the impact of that could be in the international marketplace.

You stated, just a few moments ago, that you really thought an issue here was how we develop a strong international economic system, and I could not agree with you more, I think if history looks back on the last 8 years, one of the criticisms may well be that we failed to develop an international strategy to compete with our trading partners, especially in the Pacific Rim, and I am curious what you think the impact will be on our ability to compete, if we were to do something on the interest side?

Mr. KAUFMAN. Well, I believe this is an issue that deserves considerable study before you legislate. It is one of the reasons I did not include it in my recommendations, because it is very complex. You would have to apply different standards to different industries, perhaps companies. There is also the issue the extent to which some of this financing could be taken offshore, and still become tax deductible for offshore operations, and it is not an easy issue to opine on. Thus, I don't have the answer to it at this point.

Mr. ANDREWS. Well, if we move quickly to cap the interest deduction, what do you think the response would be of some of the international marketplace, in Japan, and in the Far East?

Mr. KAUFMAN. Well, I don't think if we capped the interest rate deductions, that there would be a significant, immediate problem. I think the ingenuity of the marketplace would try to work in such a way to see if some of this financing would not be done in subsidiaries abroad, subject to the taxes of entities abroad, and therefore still be tax deductible. It is an issue that ought to be looked at, before you legislate.

Mr. ANDREWS. Thank you.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Dorgan will inquire.

Mr. DORGAN. Thank you, Mr. Chairman.

Dr. Kaufman, thank you very much for testifying. I had intended to ask you a series of questions. But let me make a statement first. Last evening I received a telephone call from one of the cities in my State. I was told that a company, Pillsbury, taken over last year by Grand Metropolitan Life, announced yesterday that a plant that they had for 28 years in Grand Forks, North Dakota, would be closed in 60 days.

With a stroke of a pen they will close a profitable plant, a plant the company acknowledges is profitable. But the new corporate entity, run by a British corporation, has decided that plant is going to be closed, and those workers have 60 days. Those workers are pawns in a large financial chess game.

This is representative of what is going on all around the country. There are not many left unaffected by what is going on in this merger and hostile takeover game, and it is a damn shame.

What we are talking about here is not just cash, not just paper, we are talking about plants, and peoples' lives. I talked to the president of the company this morning, and he asserted that he had complied with what apparently is standard business practice. I told him that we are not very used to that in North Dakota, because we consider each other neighbors. Neighbors don't tell somebody, after 28 years, that in 60 days it is over. In North Dakota you work with each other over a period of time, and maybe the workers can buy the plant, maybe they can work for 6 months or 1 year for a transition. But the Pillsbury action is not the way that neighbors treat neighbors.

I just wanted to tell you that, because this has happened in the last 24 hours, in a State that you normally don't think of as being affected by hostile takeovers.

Let me ask you a question. Regulators apparently could have done a better job on corporate mergers, according to many witnesses. According to you, they could have done a better job if they had regulated aggressively, and probably could have abated much of this fury of activity that is going on, junk bonds, and the spate of hostile takeovers, and so on.

Have these regulators in recent years been taking a fall? Have they been coconspirators or have they just been incompetent? What in your judgment is the reason that regulators have so miserably failed in doing their jobs?

Mr. KAUFMAN. Let me comment on your little anecdote first.

One of the problems that we will all face, on a longer term basis, is that the world of business and finance is becoming more global. And whether we have mergers, consolidations, or LBOs, that globalization of markets is going to continue, because of technology and the integration of the world. This is going to present an important competitive force. This is why national entities, like the United States, have to work towards more level playing fields. And we cannot really limit those competitive forces, without becoming inefficient.

Now, as to the regulators involved, I cannot make a specific judgment as to what their problem was, but I think there was an overall general problem. In an era of deregulation, it is very difficult, philosophically, for regulators to become tough regulators. When you have put in place a series of deregulations, and have not instructed regulators periodically, on the need that they make sure that institutions and markets perform prudently, there is bound to be, over a period of time, some laxity.

Let me further pursue it.

Mr. DORGAN. Don't be too charitable, on my account. I mean I——

Mr. KAUFMAN. Well, let me pursue it in these terms. Financial markets are very innovative. They are there for pay, and it is very high. They therefore attract very competent people. And for official regulators to continue to attract highly competent people on that kind of competitive basis, becomes very difficult. Financial life is more intricate.

When you look at assets and liabilities of financial institutions, they are very complex, and the linkages between assets and liabilities are interwoven. To be a highly observant regulator, an examiner requires extraordinary skill, and for a good part, many of the most skillful people are attracted to the private sector. It is up to the Government to make sure that skillful people are there, and that the regulators are instructed to be keenly observant.

Furthermore, we do have competing regulators. We have all kinds. We have a Comptroller of the Currency, we have FSLIC, we have FDIC, we have Federal Reserve, we have State regulators. There is an army of participants, but there is no one that has a total overview of the system and its integration, except perhaps the Central Bank, which of course has limited responsibilities when it comes to all financial institutions.

Mr. DORGAN. Mr. Chairman, could I ask one brief question?

Secretary Brady said to us yesterday that if we leveled the playing field on equity and debt, that would largely take care of the problem. My belief is that with junk bonds representing the engine for much of this activity, it would not abate the problem at all.

Could you give me your observation on that? Is the Secretary right or wrong?

Mr. KAUFMAN. This is why I believe that prudential rules should be established for financial institutions, particularly for deposit institutions, which are at the heart of the payments mechanism. Rules of prudential conduct, fiduciary responsibility, they should be promulgated by Congress, or they should insist that the regulators, particularly the Federal Reserve, enforce some of these.

Mr. DORGAN. So you do not necessarily agree with the Secretary?

Mr. KAUFMAN. In that sense, I differ.

Mr. DORGAN. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Kaufman, thank you very much. That pretty much concludes our exchanges. I guess by the amount of interrogation that you have gone through, you can see that there is a genuine interest in this problem, and I hope that we can feel free in the future, if need be, to call on you for some further advice, and I want you to know how much we appreciate your taking this time out to join us.

Mr. KAUFMAN. Thank you, Mr. Chairman.

[The following questions from Congressman Coyne, and responses were subsequently received:]

Questions for Henry Kaufman, Henry Kaufman and Company.

From William J. Coyne, M.C.

In your speech before the National Press Club earlier this month, you said:

> It is questionable whether any Government-insured deposits should be allowed to be invested in these loans or in the junk bonds that are then issued to retire them.

I believe that it is appropriate for the federal government to impose risk-limiting requirements on FDIC, FSLIC, and PBGC guaranteed funds. However, some critics have said that it is very difficult to determine in advance which bonds are junk bonds and which loans are excessively risky loans. Can you recommend criteria on riskiness that Congress can consider when deliberating on how to regulate investment of insured deposits?

Certain federal agencies -- such as the Treasury, the Federal Reserve Board and the SEC -- already have the authority to promulgate regulations that would slow down the LBO movement and reduce the potential for a wide-spread debt problem in the event of a recession. Do you think it would sufficient for these agencies to use that authority to slow the LBO movement or do you feel that more far-reaching legislation is in order?

Do you favor increased disclosure of financial and economic plans for firms proposing a takeover or merger?

Would you support legislation that would mandate a longer period of time between the first proposal of a takeover and the final consummation of the transaction?

According to a report that appeared in the New York Times last December, the commission of the European Community has proposed legislation that would harmonize rules on corporate takeover for its twelve member nations. Do you believe that similar legislation might help the United States?

HENRY KAUFMAN & COMPANY, INC.

Henry Kaufman

767 Fifth Avenue
New York, N.Y. 10153
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March 2, 1989

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Rostenkowski:

In response to your request pertaining to the hearings on Tax Policy Aspects of Mergers and Acquisitions, I am hereby submitting the following answers to the additional questions posed in your letter of February 21 (see attached).

1. The asset should have a credit rating of A or higher and should have a maturity of no more than several years.

2. I believe that the regulatory authorities should utilize their full power to enforce conservative lending and investing practices by financial institutions. Nevertheless, their powers probably are inadequate to fully address this issue. It would be very helpful if in the case of deposit institutions in particular that much more narrowly defined investment criteria be promulgated by Congress when these deposits are Federally insured.

3. I believe that this is not necessary because such disclosure is needed and provided when the negotiations take place between the parties involved.

4. I suspect that it would be helpful to have about a 90-day period of gestation in which the proposals are presented and then reviewed by the participants involved and finally consummated.

5. It would be very helpful if major industrial countries could establish uniform codes of behavior in all financial matters. This should include not just matters involving merges and leveraged buyouts but also uniform trading standards, accounting standards, and official supervisory oversight.

Sincerely,

Henry Kaufman

HK:HK

Chairman ROSTENKOWSKI. President Kirkland.

The Chair would like to announce that its intentions are to work through lunch.

Could I ask our guests, those who wish to retire, retire as quietly and quickly as possible?

Certainly Lane Kirkland is no stranger to this committee, for the 8 years that I have sat in the Chair, I think as far as witnesses are concerned, Lane Kirkland, the president of one of the most outstanding affiliations in the country, has extensively shared with us his views. And I want you to know, Lane, we appreciate your joining with us today, and we are looking forward to your testimony, and I guess you will recognize how concerned we are about the issue that is before us, and we certainly hope that you can make some contribution to helping us solve it.

STATEMENT OF LANE KIRKLAND, PRESIDENT, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS, ACCOMPANIED BY ROBERT M. McGLOTTEN, DIRECTOR, DEPARTMENT OF LEGISLATION, AND RUDOLPH A. OSWALD, DIRECTOR, DEPARTMENT OF ECONOMIC RESEARCH

Mr. KIRKLAND. Thank you very much, Mr. Chairman.

I have with me today, on my left, Robert McGlotten, director of legislation, and on my right, Rudy Oswald, director of research for the federation.

With your permission, I would like to give an abbreviated version of the longer statement that I have submitted to the committee.

Chairman ROSTENKOWSKI. Your entire statement, Mr. Kirkland, will be included in the record. If you would like to abbreviate, that is fine.

Mr. KIRKLAND. Thank you.

Mr. Chairman, members of the committee, thank you for conducting this hearing, and affording me the opportunity to testify on the subject of leveraged buyouts.

We look forward to working with you and members of the other committees, as we search for legislative solutions to this crucial financial issue.

We also hope to work closely with the committee, and the Education and Labor Committee on the subject of pension terminations and reversions, a serious problem for many thousands of workers whose employers are involved in mergers, takeovers and acquisitions.

Last week I testified on LBO's before the Senate Finance Committee, which as you know, is also investigating the tax policy issue with respect to these deals.

Accordingly, my presentation today does not differ to any great extent from my earlier testimony. We continue to stress two basic points, that Congress needs to address the leveraged buyout problem, and that the Tax Code is the best place to start, because it is the root of the problem, or certainly one of the roots.

The AFL-CIO takes a dim view of Wall Street's current fascination with the leveraged buyouts. We see great energy and vast resources being committed to an obscene struggle among the Nation's corporate elite, on yielding no expansion whatsoever, on America's capacity to produce goods and services, or its competitive strength.

While corporate America incurs billions upon billions of dollars in new debt, not one new product is made, not one new service is marketed, not one factory is built, and not one job is created.

We know who the winners are in this high stakes game, they are the speculators who initiate these deals, and make quick and easy mega-profits, not necessarily by prevailing in their takeover efforts, but often just by playing the leveraged buyout game, and collecting huge greenmail payments. They are the investment bankers, and lawyers who pocket fat fees, millions of dollars per deal, and they are the corporate managers who are enriched by golden parachutes.

Sadly enough, these deals produce many more losers than winners, and we know, all too well, who they are. When corporate assets are sold off to meet this unprecedented new level of corporate debt, when subsidiaries and divisions are sold off, when factories are shut down, stores and offices closed, wages and benefits reduced, pension money used to pay greenmail, it is the working Americans who pay the price, with the loss of their livelihoods, and the debasement of their communities.

We estimate that the long list of mergers, takeovers, and leveraged buyouts over the past decade has directly resulted in some 90,000 of our members losing their jobs. Many thousands more have been forced to take wage and benefit reductions as a result of corporate restructuring, in the face of massive new debt.

It is difficult not to be skeptical, or even downright cynical, at the reactions of the feeble attempts to rectify this latest craze.

A few years ago, when large companies were gobbling each other up, we were told that bigger is better, that conglomerations would help corporations to become stronger and more efficient to compete in the world economy.

Now that takeovers are largely finance driven, and corporate disintegration through leveraged buyouts, is all the rage, we are told that smaller is better, and that companies are more efficient when broken up, and their assets sold off piecemeal.

One thing we know for sure, while the rest of the industrialized world soberly invests in the future, our financial elite, with the complicity of major banks, brokerage firms, investment houses, prestigious law firms, and the best and brightest graduates of our leading universities and business schools is engaged in a drunken short-term revel, whether or not we crash and burn is not the question, only when, and how many casualties there will be.

The AFL-CIO takes no pleasure in this prediction. We know the ultimate price will not be paid by the dealmakers. They will take the money and run. Rather, it is the working people of America, those whose voices cannot now be heard above the din on Wall Street, who will suffer.

Despite what we believe to be the strong sentiment of the American people, that the proliferation of leveraged buyouts is not in the public interest. Our Government, through the Tax Code, is subsidizing, and therefore encouraging these questionable deals. The law favors the financing of corporate activities through debt, rather than equity. We tax debt as much as 87½ percent lower than equity, as though this were good public policy.

It has become clear under the present circumstances that it is not, this preferential treatment of debt has brought a vast increase in corporate indebtedness. A shrinking of the tax base, by as much as $50 billion, and a switch from productive investment to speculative paper transactions, that has added a serious new element of risk and vulnerability to an already shaky and fragile economic situation. Consistent with a notion that the tax laws should safeguard the public interest, we suggest that the committee and the Congress move swiftly to correct this situation by adjusting the code to disallow the corporate interest deduction for debt to finance an LBO, a takeover, or the retirement of equity.

While I am no tax expert, you don't have to tell me that this won't be the easiest thing in the world to do. I understand that you would have to carefully craft the definition, and create tracing rules to prevent debt recharacterization, and to ensure that the spirit of the law is observed.

I am sure, however, that this committee has the technical skills to devise a workable approach. This committee and the Congress have previously held that all interest payments are not sacrosanct. You have found the necessity and the means to make certain discriminations and the deductibility of interest for individual filers, there is no reason why the same approach should not be applied to corporate returns.

The only other solution that has been mentioned in this area, that is a new corporate deduction for dividend payments, or a personal deduction for dividend receipts, makes no sense, whatsoever, for a variety of reasons, and particularly under the current budgetary circumstances. The Treasury simply cannot afford the revenue hemorrhage.

We also ask that the committee consider further measures aimed at eliminating greenmail payments and golden parachutes. With regard to the latter, the practice of paying off departing management is particularly insulting to workers who have no such protections.

Currently, greenmail payments are subject to a 50-percent excise tax, while golden parachutes are taxed by a 20-percent excise. The continuation of these practices, however, leads us to believe that the current provisions are not strong enough.

The AFL-CIO has other important concerns about leveraged buyouts, such as the laws which enable prevailing companies and hostile takeovers, to terminate established bargaining relationships, and cancel collective-bargaining agreements in force.

In addition, current law has enabled employers to take $18.7 billion in pension money this decade, from nearly 2 million American workers, through pension fund terminations, and reversions, related to mergers, takeovers, and leveraged buyouts.

We want to change these laws, to protect workers, and we will pursue this agenda in the Congress, before the proper committees.

Mr. Chairman, workers have a vested interest in the long-term stability of the corporations which employ them. They and their families are inextricably linked to the continuing production of goods and services on their native soil, and in their hometowns.

We in the labor movement, want to be able to negotiate in good faith, across the table, with thriving private companies, managed by substantial serious people, who create and sell useful things.

The leveraged buyout mania is working to the detriment of these interests, as well as to the economic future of this Nation. We strongly disagree with those who suggest inaction. And we hope these hearings are the first step toward the enactment of legislation designed to address the problem, rather than mere exercises, full of sound and fury, signifying nothing.

That completes my testimony, Mr. Chairman, I will be happy to answer any questions.

[The statement of Mr. Kirkland follows:]

89-3

Testimony of Lane Kirkland, President
American Federation of Labor and Congress of Industrial Organizations
Before the House Ways and Means Committee on Leveraged Buyouts

February 1, 1989

Mr. Chairman:

The AFL-CIO, on behalf of the 14 million working American men and women who are members of our 90 affiliated national and international unions, thanks you for conducting this hearing and affording me the opportunity to testify on the subject of leveraged buyouts and other highly leveraged corporate restructurings. We do so because the Committee's inquiry into the effect of the tax laws on corporate restructurings could not be more timely. We look forward to working with members of this Committee in addressing this phenomenon and its attendant impact on Americans. In addition, we hope to work closely with you and members of other appropriate committees--particularly the Education and Labor Committee--on other matters related to LBOs, including the crucial issue of pension terminations and reversions.

By any measure, the country as a whole, and working people in particular, are paying a wholly unacceptable price to the financial manipulators who arrange highly speculative, highly leveraged buyouts and takeover deals. The colorful newspaper accounts of "hostile maneuvers," "greenmail payments," "poison pills," and other arcane aspects of the "takeover game" are fascinating but misleading. These stories give little attention to the adverse impact of these deals on plain working people throughout the nation and on the economic health of their communities.

We estimate that the long list of mergers, takeovers and leveraged buyouts over the past decade has directly resulted in some 90,000 of our members losing their jobs (see attachment). Many thousands more have been forced to take wage and benefit reductions as a result of corporate restructuring and the replacement of equity with massive amounts of debt. All too often, this debt is assumed not for the purpose of industrial expansion or increased competitiveness, but as a stockmarket manipulation ploy which serves little purpose other than to line the pockets of speculators with fast-earned mega-profits, as well as their investment bankers and their lawyers with fees running into the millions. The employees of these companies, who do the hard work to be done, are frequently placed at great risk while billions of dollars are channelled into hands that neither create nor produce goods or services.

In many cases, it does not matter whether the initial hostile takeover is successful, only that the company has been put into play. For example, the takeover of Crown Zellerbach's James River Paper Company by James Goldsmith in 1985 was followed by the layoff of 1,000 employees. A subsequent attempt by Goldsmith to gain control of the Goodyear Rubber Company was successfully fought off by the firm. However, in doing so, Goodyear added $2.6 billion to its corporate debt, which led to the shutdown of its tire plant in Cumberland, Maryland, the loss of 800 jobs there, as well as sizeable reductions at the company's headquarters and in various shops making other products in Akron.

In 1986, Safeway Stores' defense against a takeover by the Haft group included the payment of greenmail, which left the Hafts with $100 million in profit for their efforts, and ended in a leveraged buyout under the auspices of Kohlberg, Kravis and Roberts. The company incurred a debt of about $4.1 billion and quickly embarked upon a program of shutdowns and sales of stores. The number of job losses at Safeway totalled about 9,500.

The common ingredient in these and other restructurings is a quantum increase in debt, which then gives rise to extraordinarily high servicing costs, pressures to cut wages and benefits, and close-downs or sales of assets and operations.

Win or lose, those who initiate the takeovers usually end up pocketing millions of dollars, often through the payment of "greenmail." Corporate management is often protected from the dire consequences of a takeover by specially-designed "golden parachutes." The losers in these deals, quite consistently, are none other than the stakeholders in the affected company, particularly the long-term workers, to whom "golden parachutes" are not available.

There is no rhyme or reason to this latest Wall Street bubble. A few years ago, when large companies were gobbling each other up, we were told that "bigger is better," that conglomeration helped corporations become stronger and more efficient to compete in the world economy. Now that the takeover craze has become finance-driven and corporate disintegration through leveraged buyouts is the rage, we are told that companies are more efficient when broken up and their assets are sold off piecemeal.

While the rest of the industrialized world soberly invests in the future, our financial elite--with the complicity of major banks, brokerage firms, investment houses, prestigious law firms, and the "best and brightest" graduates of our leading universities and business schools--is engaged in a drunken short-term speculative revel. Whether or not we crash and burn is not the question, only when and how many casualties there will be.

The AFL-CIO takes no pleasure in this prediction. We know that the ultimate price will not be paid by the dealmakers; they will take the money and run. Rather, it is working people--whose voices cannot now be heard amid the current financial uproar--who will suffer.

What, then, is to be done? There is a growing consensus that a large part of the grotesque profits from these deals stems from the tax system's disparate treatment of debt and equity. There are complex practical and technical problems that must be overcome in correcting the current situation, but we believe that those problems are not insuperable, and that the current system is creating such serious economic losses that corrective action must be taken by this Committee and the Congress.

Even if one were to take a much kinder and gentler view of LBOs and hostile takeovers than we do, one thing is clear: the United States government should not be subsidizing these questionable deals by providing tax subsidies. But this is precisely what the tax code does. The code accords a tax advantage--tax subsidy if you will--to financing corporate activities through debt rather than equity.

Indeed, since 1981, the relative tax advantage of corporate debt has increased as a result of the sharp cuts in individual and corporate marginal tax rates, to the point whereby debt could now be taxed at a rate as much as 87.5 percent lower than equity, compared to a differential of 19.7 percent prior to 1981.

As a result, according to the Federal Reserve Board, from 1981 to 1987, the non-financial corporate business sector retired $295 billion in equities while adding $813.2 billion to net corporate indebtedness.

The switching of corporate capital structures from equity to debt also undercuts the corporate contribution to the costs of running the federal government and generates revenue losses that make the solution of the federal budget deficit problem even more intractable. If the share of corporate income excluded from taxes as a result of interest payments had stayed at its 1980 level, the corporate tax base in 1985 would have been nearly $50 billion higher than it was in fact.

As a tax policy matter, there is no reason to treat a dollar of debt-financed income any differently from a dollar financed by an equity investment--in fact, the distinction between the two is one of degree rather than a hard and fast distinction in kind. And, as a matter of national economic policy, the preferential tax treatment of debt has resulted in the siphoning off of funds to corporate deal-makers that otherwise would have been used to increase the nation's productive capacity and potential. This switch to debt for non-productive paper transactions has added an element of risk and vulnerability to an already shaky and fragile economic situation.

As a practical matter, this Committee is faced with the following choice: to continue the present rules under which the U.S. Treasury subsidizes highly-leveraged deals despite their deleterious effects, or enact a limit on interest deduction for corporate debt. The choice between those alternatives, while complex in its successful accomplishment, is an easy one as a matter of principle. So that there can be no misunderstanding, I wish to stress that the only other alternative that has been mentioned--a new corporate deduction for dividend payments--makes no sense whatsoever, particularly under current circumstances, in which the government's fiscal situation precludes any tax change that promises a large revenue loss to the Treasury.

It is our position, then, that since Congress has come to the judgment that it is proper to be selective in determining which types of interest payments shall be deductible on individual tax returns, it is time, in the interest of sound public policy, to make similar discriminations with regard to the deductibility of interest on the various types of corporate debt.

The amendment to the code most closely fitted to the immediate problem would be to disallow the deduction for debt to finance an LBO, a takeover, or the retirement of equity. While I am not an expert in the technicalities of formulating and administering the federal corporation tax, it is my understanding--and this accords with common sense--that such an amendment would require careful safeguards to prevent the evasive recharacterization of debt that is in fact incurred for these purposes and detailed tracing rules to assure that debt originally incurred for these purposes is not turned over into deductible debt obligations. These are not easy tasks, but I am convinced that this Committee has the technical skills to devise a workable approach and that the need is so great and so plain and obvious that the effort must be made.

In addition, the AFL-CIO is opposed to "greenmail" payments and "golden parachutes." The practice of paying off departing management, in particular, adds a level of financial and personal insult to workers who have no similar protections.

Current law taxes "greenmail" payments through a 50 percent excise tax, while "golden parachutes" are taxed by a 20 percent excise. Since these practices are continuing, we believe the current provisions to be inadequate. We ask that the Committee look into further measures aimed at eliminating them.

I also wish to digress for just a moment to underline two other related points of great concern to American workers which stand separate from the tax issue I have just discussed but are important nonetheless.

First, there is a natural tendency to focus on new developments and to take long-standing and equally destructive practices for granted. Thus, the discussion today is almost exclusively about LBOs and hostile takeovers, while other forms of corporate restructurings are hardly mentioned at all.

Yet, from the long-term employee's standpoint, all reorganizations in which one corporation succeeds another are the same: the prevailing, or "new," employer is free to hire a new workforce and in so doing may terminate established bargaining relationships and cancel collective bargaining agreements in force.

We believe this is entirely unfair and contrary to the interests of working people and of a well-functioning economy. Permitting arbitrary conduct of this kind undermines the system of mutual employer-employee commitments that provides the foundation for high company productivity. That being the case, the AFL-CIO's first priority in the merger and acquisition area is a set of employee protections across these corporate transitions no matter what their form. We will pursue this agenda in this Congress before the proper committees.

Finally, since this Committee has joint jurisdiction over ERISA matters, I wish to note that the AFL-CIO strongly supports a change in that law, under which employers have unilaterally terminated pension plans and used excess assets to fund mergers and acquisitions. Since 1980, $18.7 billion has been taken from pension funds by employers, affecting some 1.9 million participants. Workers whose pension benefits have been terminated by corporate raiders or corporations targeted for takeover have been left with annuities whose value is far less than the original pension promise.

Our position on this issue is simple. The assets in a pension fund represent deferred wages for workers covered by the plan and are explicit trade-offs in exchange for a pension that is expected to grow in the future and provide economic security to retirees. Thus, in the context of both merger activity and pension reform, we strongly urge Congress to develop comprehensive legislation that will end the termination of pension plans without significant worker participation and protection. The 10-percent excise on pension plan terminations was raised to 15 percent as part of the 1988 Technical Corrections Act to give Congress the opportunity to develop a comprehensive strategy on the issue of pension plan terminations. We stand ready to assist in developing whatever legislation is required to address this problem.

This completes my testimony. I will be happy to answer any questions members of the Committee might have.

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Number of Jobs Lost as a Result of Takeover Attempts, Takeovers, and Leveraged Buyouts

Unions Involved	Circumstances	Estimated Number of Jobs Lost
United Food and Commercial Workers	Safeway Stores was subject to a takeover attempt by the Dart Group Corp., owned by the Haft family of the Maryland suburbs of Washington, D.C. Safeway avoided the takeover in two ways. First, it settled with the Hafts by acquiring their shares at a price which left them with $100 million in profit and also paid them an additional $59 million to buy back from them rights to purchase stores in the Washington, D.C., area, which had been given to them originally. Then Safeway management went through a leveraged buyout under the auspices of Kohlberg, Kravis, and Roberts, buying back enough shares from the public to gain control of the Safeway corporation. The Safeway corporation then ended up with a debt of about $4.1 billion.	9,500 jobs lost
	Safeway has since embarked upon a program of closedowns and/or sales of stores in a few regions of the country. This included all 141 stores in the Dallas-southwestern states region, as well as a regional headquarters and distribution center. In smaller communities on the Eastern Shore of Maryland and Delaware, 8 stores were closed down. Other areas were also affected, and the number of job losses continued to grow.	
	In January, 1988, the Kansas City Division, involving 3,400 employees, was sold in a local management LBO; workers who had been through one round of concessions in their previous contract negotiations had to go through another round. In March 1988, Safeway Stores in the Arkansas Division, including stores in Arkansas, Louisiana, and northern Texas, were sold in a local LBO; and 2,500 union employees were forced into substantial wage and benefit cuts in order to preserve their jobs.	
	Lucky Stores, a western states food supermarket and general merchandise store chain, fought off a raid by Edelman and ended up in a much weaker financial situation. The Lucky Stores management retained control of their corporation but decided to liquidate all of their Gemco general merchandise stores in California and Arizona and concentrate on its food store business. The Gemco stores closedown caused the net unemployment of 6,000 out of 14,000 persons that had been employed in the stores; the rest had employment rights for vacancies in other stores owned by Lucky Stores under a union contract.	6,000 jobs lost
	Both the Safeway Stores and the Lucky Stores contractions are a reaction to a larger debt burden which causes stores (or plants) that had previously been marginal producers of net earnings to become submarginal, because higher earnings are required to service the debt. In such circumstances, stores or operating units may be shut down or sold to people who have stores in the same locality or region or plants	

Unions Involved	Circumstances	Estimated Number of Jobs Lost
	producing the same products. The latter may close down some acquisitions or reduce the size of the operation.	
	In February 1988, in order to stave off a hostile bid by the Hafts (trading as Dart Group Corp.), Stop & Shop stores enlisted the services of KKR to structure a leveraged buyout which was done successfully at a price per share of stock which added $1.4 billion in outstanding debt to S&S, which then sold 58 of its Bradlees department stores to help pay down the debt. Bradlees stores, employing 3,000, were closed down; and the stores leased to Hechinger Company, a hardware and housewares chain with stores in Maryland, Pennsylvania, and Virginia, who presumably would use the stores as added outlets in its chain; but Hechinger then decided the stores would compete with those already in its chain and sold the leases. There were 3,000 former Bradlees employees out of work.	3,000 jobs lost
	In January 1988, Grand Union, operator of 360 food supermarkets, was spun off by General Electric of France through a leveraged management buyout. In March 1988, Grand Union sold its 52 Colonial/Big Star stores in Virginia and North and South Carolina to Harris-Teeter corporation, an adamant anti-union employer. Two thousand union members lost their jobs and their union contracts.	2,000 jobs lost
Glass, Pottery, Plastics and Allied Workers	Diamond Bathurst, which was a company with three plants, acquired three other firms (Thatcher Glass, Glass Container Corporation, and Chattanooga Glass Company). It then, in 1984, had a total of 22 plants with 7,883 employees. It closed eight of the plants and now has only 4,075 employees.	3,800 jobs lost
	Owens-Corning Fiberglas fought off a takeover attempt by the Wickes Companies, during which it bought back stock that cost about $3.5 billion. It ended up with a debt of $2.6 billion and a large cutback in operations, and the number employed was reduced by between 12 and 13 thousand.	13,000 jobs lost
	In April 1988, there was an attempted takeover of the American Standard plumbing fixture manufacturing company by Black & Decker, a manufacturer of hand tools and household electronics.	350 jobs lost
	American Standard embraced Kelso and Co. as a "white knight" to keep out Black & Decker, who was willing to retreat for related legal reasons.	
	The State of Delaware, in which American Standard was incorporated, had enacted a law that would greatly delay, if not wholly block, a hostile takeover attempt. It required the hostile suitor to obtain 85 percent of outstanding shares before he could assume control. Black & Decker	

Unions Involved	Circumstances	Estimated Number of Jobs Lost
	sued in federal court to have the law declared unconstitutional on grounds that it violated the "interstate commerce" clause. The court ruled against Black & Decker, which then sold its share holdings to Kelso and withdrew. Kelso acquired enough shares in the market to gain control. Before the Kelso "rescue," in negotiations with the union, the American Standard management had cited company assets totalling $3 billion and debt of $400 million. After the Kelso-management stock purchase, the debt had mounted to a staggering $2.8 billion, and the company had to borrow about $2.7 billion. In October 1988, the company announced that it would close down the Wauregen, Connecticut, plant, where 341 employees were employed and would lay off about 16 salaried employees at a Tiffin, Ohio, establishment.	
Retail, Wholesale and Department Store Union	Gimbels Department Stores. In the 1970s, the Batus corporation, a British holding company, obtained majority control of the Gimbels Department Store operation, including its subsidiary, Saks Fifth Avenue. Batus held the property and allowed it to be operated as department stores until the real estate on which the Gimbels stores were located became valuable. Then it closed the Gimbels stores in late 1986, early 1987, to rebuild for other uses. (The most profitable Saks Fifth Avenue stores have remained in operation.)	5,000 jobs lost
	Jacob Suchard of Switzerland acquired Brock Candy and closed down one of the three plants.	160 jobs lost
United Rubbber, Cork, Linoleum and Plastic Workers of America	In 1986, Goodyear Tire & Rubber Company fought off a takeover attempt by James Goldsmith. Goldsmith walked away with $92 million in greenmail. To buy back his stock, and shares held by the public, Goodyear added $2.6 billion to its debt. It greatly reduced and then closed down operations at its Kelly Springfield Tire Company plant in Cumberland, Maryland, which had employed 800; and through forced early retirements and layoffs, also had a 600-person reduction of its headquarters staff; and then in 1988, induced another 438 in Akron, Ohio, and at tire plants elsewhere, to retire early.	1,800 jobs lost
United Paperworkers International Union	After Crown-Zellerbach's James River paper company was acquired by James Goldsmith in a hostile takeover, 1,000 employees were laid off in October 1985.	1,000 jobs lost
United Steelworkers of America	When Lykes shipping company took over the Youngstown Sheet and Tube Company in 1969, the head of Lykes announced that he would use the cash flow of Youngstown Sheet and Tube, about $100 million a year, as he saw fit. He proceed to do so, and one of the two	Total of 13,800. Estimated 13,100* of total of 109,000 work force reduction between 1971 and 1986 due to closedown of

Unions Involved	Circumstances	Estimated Number of Jobs Lost
	Youngstown plants, the Campbell Works in Youngstown, an older plant, was allowed to run down. Instead of having equipment replaced, the Lykes company milked Youngstown Sheet and Tube. Youngstown Sheet and Tube also had another newer plant which was in good shape, and Youngstown Sheet and Tube assets were later sold to Jones and Laughlin, which then was merged with LTV. The latter closed the Campbell Works, which had employed 4,000. One subsidiary of an acquired firm, Enduro Products, had to be sold off for anti-trust reasons; and it went bankrupt, and 700 jobs were lost. In 1984, LTV also acquired Republic Steel, and it then closed more of its plants.	merger acquisition plants. Also, 700 jobs lost at Enduro Products after sell-off.
Amalgamated Clothing and Textile Workers Union	Pacific Holding Corp. through a leveraged buyout acquired Cannon Mills Co. in January 1982 for $413 million. After the acquisition, many mills were closed or sold. In January 1986, most of the remaining plants were sold to Fieldcrest, which closed or sold 4 mills. Employment decreased from 23,200 in January 1980 to 15,500 in December 1985.	9,200 jobs lost
	Tultex, Corp. acquired Washington Mills in July 1982 for $17 million; closed Marion, North Carolina, plant in November 1984.	500 jobs lost
	Dan River -- leveraged buyout by investor group for $154 million in May 1983; subsequently, plants employing 4,086 closed or sold -- employment reduced from 12,000 to 8,000.	4,000 jobs lost
	Cone Mills Corp. -- leveraged buyout for $420 million by members of existing management March 1984 -- when employment was 10,944; sold Union Bleachery plant in Greenville, South Carolina -- employment in November 1985, 10,000.	940 jobs lost
	TI-Caro, Inc. -- leveraged buyout for $190 million by members of existing management May 1984; plants sold off in Burlington and Graham, North Carolina, and closed a plant in Cleveland, Tennessee -- employment reduced from 5,700 to 4,700 by November 1985.	1,000 jobs lost
	Gold Mills/Saratoga/FFF by Guilford Mills --fired 350 employees at Saratoga when both Saratoga plants closed (1986).	350 jobs lost
	Cluett, Peabody & Co., Inc. merged into West	3,300 jobs lost

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*Between 1971 and 1986, LTV closed a number of plants and dismissed 78 percent of the work force of the three acquired companies. Six other major steel companies reduced their combined work force by only 66 percent over the same period. If the additional 12 percent of the LTV reduction was attributed to the effect of excessive merger acquisitions, it would account for 13,100 of the dismissed workers.

Unions Involved	Circumstances	Estimated Number of Jobs Lost
	Point-Pepperell January 1986 -- 10 U.S. plants sold or merged.	
	Blue Bell, Inc. leveraged buyout (1984) for $470 million, then acquired on July 27, 1986 by VF Corporation. Employment reduced from about 20,000 to 18,800.	1,200 jobs lost
	Health-Tex -- leveraged buyout for $230 million in 1985; closed three plants (1986-87).	1,300 jobs lost
	Levi Strauss & Co. -- leveraged buyouts for $1.7 billion by investor group -- sold many plants to meet payments incurred by the buyout.	5,200 jobs lost
International Chemical Workers Union	Granite City Steel bought out by National Intergroup and Nippon Steel in 1984.	250 jobs lost
	MK Laboratories of Fairfield, Connecticut, go bankrupt after LBO in 1988.	140 jobs lost
	American Salt LBO by General Host in 1988.	60 jobs lost
	Hilton-Davis LBO of Sterling Drug in Cincinnati.	300 job reduction
	Cities Services plant in Copperhill, Tennessee, 650 loss after Tennessee Chemical LBO in 1982.	650 jobs lost
	Dow bought Morton plant in Kanakee, Illinois in 1984 -- closed production; closed distribution center in 1988.	170 jobs lost
	Four original Harshaw plants in Ohio and Kentucky bought by Engelhard from Kaiser in 1988.	Cutbacks -- net loss of 390 jobs
United Auto Workers	General Motors sold TEREX Division to IBH Holding AG of Germany through an LBO in December 1980 after a struggle and bankruptcy; and TEREX acquired through second LBO by Northwest Engineering in 1987, and ceased operations shortly thereafter. Total job loss -- 2,800 workers.	2,800 jobs lost

TOTAL ESTIMATED NUMBER OF JOBS LOST: 91,160

HBS:ehb

1/25/89

Chairman Rostenkowski. Thank you, Mr. Kirkland.

You mentioned in your testimony that we should look into proposals to tighten provisions regarding greenmail payments and golden parachutes.

Mr. Kirkland, do you have any legislative suggestions, or could you give us any idea of what you would do to curtail that activity, more specifically?

Mr. Kirkland. I would increase the taxes, the excise taxes, and make the language tighter in the area of greenmail payments and golden parachutes.

Chairman Rostenkowski. What about nondiscrimination rules, Mr. Kirkland, for golden parachutes?

Mr. Kirkland. I would buy that.

Chairman Rostenkowski. Spread the wealth around a little bit, huh?

Mr. Kirkland. Yes.

Chairman Rostenkowski. Mr. Rangel.

Mr. Rangel. Thank you, Mr. Chairman.

Let me thank you, Lane, for an outstanding job that you have done in being specific as to the impact that these takeovers have on workers.

I have been visited by a lot of people from the investment banking world, and they have tried to impress me, without a lot of statistics, how capital is capital, whether it is equity, or whether it is borrowed, and that when these mergers identify weak management, and low productivity, and they have an opportunity to improve plant, equipment, work force, to make America stronger, and more competitive, that what they are talking about, are an increase in production, an increase in jobs, and all you talk about are losses in jobs, and seniority, and jeopardy of pension funds, have you experienced circumstances where your membership have dramatically increased as a result of an LBO?

Mr. Kirkland. I know of no such experience, sir. We have examined the instances that we have been able to trace, and I think you will uniformly find in each case there has been a job loss or other economic setbacks suffered by the working people.

I suggest—perhaps you have, but if you have not—that you peruse the Wall Street Journal this morning. On the front page, you have a detailed story of the impact not just of an actual buyout, but the apprehension of one, in Oklahoma, at Bartlesville, OK, where the Phillips Petroleum Co. faced this prospect. The articles describes the fear that breed takeovers in the community as well as in the work force. It is rather extensively detailed there, including the fact that in some places, they have put tickers up in the plants so that the average worker can judge the prospects of their being raided or taken over by any movement of those stock prices. It is remarkable and very sad.

But also, inside, on the editorial page, the other side of that "Chinese wall" there, there is an article by an eminent professor at Harvard Business School, one of the breeding places of the best and the brightest, saying how wonderful leveraged buyouts are and what a great public servant Drexel Burnham is and so forth.

Which do you believe? I believe the story on the front page. That jives with my experience.

Mr. RANGEL. Well, this is a pretty——

Mr. KIRKLAND. And I am familiar with these arguments: "It is a good thing, because it stimulates complacent corporations and shakes up entrenched management." I would put it this way—I hold no brief for the virtues of American management, and if you want to put together any litany of their sins and offenses, I could add a few items, but LBO's are not the cure. Ancient Rome was undoubtedly decadent, but I doubt if its future was much enhanced by the restructuring imposed by the Vandals, the Visigoths, and the Ostrogoths. And that is the closest parallel to what is actually going on.

Mr. RANGEL. Well, as I was starting to say, this is pretty dramatic testimony in addition to the revenue losses that we have by subsidizing debt interest.

I am going to ask staff to look into at least the fiscal impact of the unemployment that is visited upon us as a result of this, the exposure to the pension funds, and certainly we cannot measure in dollars and cents the impacts that it is having on American families.

So thank you so much for your testimony.

Mr. KIRKLAND. Thank you.

Chairman ROSTENKOWSKI. Mr. Pickle.

Mr. PICKLE. Mr. Chairman, thank you.

Mr. Kirkland, I was not here for all of your testimony, but I have been reading it some this morning. I want to observe first that I think we have overlooked largely the fact that in these big LBO's—and many of the mergers and acquisitions—a lot of people have lost their jobs. I do not think we have concentrated on that.

Quite often, when they put these big LBO's together, they immediately want to sell off some assets to try to pay for what they put together, and that means people losing their jobs.

I cannot say that they should not have restructuring, because sometimes it may be better that that would happen. But on the face of it, it looks like a serious matter, and I think we ought to be more cognizant of that.

Now, the second thing I want to talk to you about, though, is in the area of the pension fund reversion. And you said that you want to work with our committee, because we have joint jurisdiction.

Mr. KIRKLAND. Yes.

Mr. PICKLE. And I think we should, and I look forward to that. We must work together.

Now, you have said that some, I think, $18 billion actually reverted as a result of mergers and LBO transactions. And you say that the pension plans are unilaterally canceled, and then employers use these excess assets to fund these mergers and acquisitions. Perhaps they have and perhaps they have not. It is the law that they can do it.

But I want to ask you, have you been able to document—you, the AFL–CIO—a correlation between leveraged buyout transactions and the subsequent termination of company pension plans? Is there a correlation to it?

Mr. KIRKLAND. The $18.7 billion, which is our estimate in this testimony, is all related to all terminations and reversions, including buyouts.

Mr. **Pickle**. Now, you mentioned the $18.7 billion, but let me go a step further on that. Have you determined how much of this $18.7 billion has been used to fund acquisitions and mergers as opposed to being invested directly in the company's plant or equipment? Have you got any documentation on that?

Mr. **Kirkland**. We derived that figure from the reversions related to mergers and acquisitions, but let me provide more for the record.

[The following was subsequently received:]

ANSWERS FOR LANE KIRKLAND'S TESTIMONY ON LEVERAGED BUYOUTS

1. Questions: In your testimony you mention that employers have unilaterally terminated pension plans and used excess assets recovered from these plans to fund mergers and acquisitions.

Have you been able to document a correlation between leveraged buy-out transactions and the subsequent termination of company pension plans? How many leveraged buy-outs have involved companies with overfunded pension plans? How many of these plans have subsequently been terminated?

Answer: Using PBGC quarterly data, we have been able to document a correlation between terminations and reversions and company sales, transfers, and mergers. Unfortunately, the PBGC data does not specifically indicate whether company reorganizations involve leveraged buyouts.

Because our recent concerns have been focused on reversions, the PBGC data we have only includes terminations that also involve reversions. There are data available from the PBGC on all terminations including those without reversions. Therefore, we believe our data understates the true relation between company reorganizations and pension terminations.

Our data shows that since 1980, 276 pension plans were terminated with reversions because of change of company ownership by sale or transfer and/or company merger with $1.4 billion in reversions to the employer, affecting 2 million plan participants.

For further information, we would recommend contacting the PBGC.

2. Question: You go on in your testimony to mention that since 1980 these asset reversions have totalled $18.7 billion.

Have you determined how much of this $18.7 billion has been used to fund acquisitions and mergers as opposed to being invested directly in a company's plant and equipment?

Do you think it makes any difference whether a company used excess pension assets to acquire productive capacity through a merger, or to gain the same productive capacity by directly investing in new plant and equipment?

Answer: As explained above, the data that are available show a correlation between terminations/reversions and mergers and acquisitions; however, this aggregate data does not show how money recaptured through a termination is specifically used for these purposes. A review of numerous cases involving terminated pension plans and recaptured assets shows the extreme likelihood that recaptured assets may be used to finance takeovers. The attached testimony of AFL-CIO Secretary Treasurer Donahue before the House Labor and Education Committee includes reference to terminations involving the use of excess assets to fund company takeover actions.

It is important to note that the only real way to calculate the total number of pension dollars involved in company takeovers, mergers, or leveraged buyouts is to calculate the following:

- o Amount of pension fund dollars invested directly in targeted companies either through stocks or bonds plus;
- o Amount of pension fund dollars invested in takeover financing such as leveraged buyout funds which provide the seed equity capital or junk bonds which provide part of the debt financing plus;
- o Amount of pension fund money reverted to employers from termination of targeted company plans.

Regarding your last question, organized labor has long sought to modify the provision in the law which allows employers to unilaterally terminate pension funds and appropriate those assets. Because this question involves facts that are situation specific, it can not be answered through a general principle or rule. Only the workers in a particular workplace can assess whether their contractual rights to wages and benefits were upheld during a merger and whether the alternatives as you pose them are completely substitutable.

Mr. PICKLE. Well, I would like to have those figures. If you have made a study, and you have some factual analysis of it, I want to have that, because I want to know are they taking these moneys and actually putting them into these kinds of transactions. We need to have that information, so if you have it, please let us have it, will you?

Mr. KIRKLAND. Pension terminations and reversions are an issue independent of the issue of pension fund investment in junk bonds. This issue is also a matter of concern to us. It is not so much that these investments threaten the actuarial integrity of the pension fund, because so far it has not been a vast proportion of these pension funds, although it is a vast proportion of the funds raised for leveraged buyouts, the junk bonds. It may be one percent of the holdings of these funds, but it is about 30 percent of the funds used in leveraged buyouts. That is an enormous amount of money. The consequences as I have tried to spell out, are deeply detrimental to working people in this country whose benefits ought to be served by those pension funds.

They should not anticipate that those pension funds will be invested in a manner deeply detrimental to their own economic interests.

Mr. PICKLE. Well, I again ask you to submit to me some documentation of those facts so we can examine that.

Mr. KIRKLAND. Yes, we will be glad to do that, sir.

Mr. PICKLE. You make one last point, that you believe we ought to put limitations on the use of these asset funds, the reversion of them. We have a limitation now, a 15 percent excise tax. We went to 10 percent, and then we went to 15 percent. Do you think we ought to go to 20 percent?

Mr. KIRKLAND. I do not think that—that would not bother me, sir, if you think it is going to help the situation. It may take a great many things, but the most important ones are the ones that I think we spelled out.

Mr. PICKLE. All right.

I thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman.

Mr. Kirkland, I would like to thank you for very good and concise testimony. You have certainly shed light on the subject matter from the viewpoint of the workers, the people who are actually getting the job done within the corporations.

I quite agree with you that the "golden parachutes" and many of these other things that are going on are of scandalous proportions. Exactly whether the cure of that is within the legislative agenda of this committee, I do not know. But I think that we do have to be very concerned by the strictly profit-motivated dismantling of corporate America. I am particularly concerned as to what is going to happen with some of these leveraged buyouts where you have got these thinly-capitalized corporations, in the event we go into an economic slump—which we are bound to go into sooner or later—or a recession. I am also concerned whether this is going to actually put parts of this country into a actual depression once these things start coming unravelled.

I want to thank you for bringing this facet of the problem to the attention of the committee and for your fine testimony.

I thank you, sir.

Mr. **Kirkland**. I can only say "amen" to that, sir.

The problem that I think leads to the consequence of these closures is the constant carrying of this enormous added burden of debt, which puts a premium on maintaining only those parts of the company which generate the highest revenues and profits to serve their debt. The profit margin required to carry that debt increases, and plants are closed not because they are not profitable but because they do not make enough profit.

We are closing not money-losing plants or unprofitable plants or uneconomic establishments. We are closing the ones that just do not make enough money, generate enough of a profit, to contribute to the carrying and servicing of this enormous debt. So those facilities are closed, some money is raised by selling them, the physical facilities, and workers are laid off.

At the heart of it, I guess, is a great, inherent inequity in the economic situation, and that essentially is this, that management knows very well how to lay off workers when the economic pressure is applied. Very, very few of them have ever figured out how to lay off a bank. If we could ever solve that problem, much of our difficulties might be over.

Mr. **Shaw**. Mr. Chairman, I yield back.

Mr. **Rangel** [presiding]. Thank you.

The Chair recognizes Mr. Guarini.

Mr. **Guarini**. Thank you, Mr. Chairman.

It is nice to see you again, Lane.

Mr. **Kirkland**. Nice to see you.

Mr. **Guarini**. And it is good to see you in good form. You pull no punches; you call a spade a spade. You know, the jobs are not only lost by the workers, but also even people in management sometimes lose their jobs. So right across the board there is a great deal of hardship that you see.

I know today that the road to the board room seems to not any longer go through the plant, but it seems to be through the accounting office, because people are thinking in terms of numbers instead of productivity. That does not make us competitive with the world market, and no wonder our trade is falling as badly as it is.

But some people think that the LBO's are good in certain circumstances. You paint a very bleak picture of that. They are all with fault. And I understand your position.

We want to make our country more competitive. Management has gotten weak. The scare is making them straighten out a bit, because I imagine there are a lot of board rooms that are starting to straighten out their act that they would not have if it were not for this scare that is going through the country in the LBO takeovers.

I would like to ask you whether or not you could comment on the effect this has on ESOP's and how ESOP's are involved and whether it is healthy in regard to the program we have for labor having participation in businesses such as ESOP's.

Have you got any comment on that?

Mr. **Kirkland**. Many ESOP's as now structured are really employee participation plans in name only. We are deeply critical of those that do not repose an effective voice in the working people who are supposed to be represented in the ESOP's with share ownership. They cannot vote it; they have very little to do with it; they really have no power whatsoever to exercise influence.

We have no quarrel in appropriate circumstances with properly structured ESOP's, which really fulfill their promise of genuine worker participation.

We have no quarrel with an ESOP's being used by workers in conjunction with the community to acquire places of employment that a company or previous employer has abandoned. To me that is very appropriate, particularly in situations of the kind that I have described, where that establishment is profitable, makes money—maybe not a great deal—but not enough for that corporation, when that corporation has the option of confining its activities to the most profitable in its empire, of going overseas, and instead of making 6 or 8 percent profit, making 15 percent, good ESOP's make sense.

That 6 or 8 percent might very well satisfy those who have a larger stake in the survival of that establishment in a community and in the work force—and I would suggest have a much greater confluence of interest than when it is operated simply by a criterion which requires it to meet this higher level of profit needed to service these debts.

Our problem—if I may continue further on a related point—there is no moral virtue inherent in debt versus equity. It does not matter, it seems to me, inherently. The problem lies in the purposes for which the debt is incurred. And it is quite clear that—I am told billions—vast sums are being used in unproductive ways—not to create investment, not to make things, not to improve things—but to make money for hustlers and to take advantage of foibles in the Tax Code. And that is bad for this country, it is bad for the workers.

I have no objection, and contrary to some of the other suggestions, I would not tax interest payments incurred for the normal, constructive improvement of the business.

Mr. **Guarini**. That is what I want to get to. It is only in regard to where there are junk bonds or situations where there is nothing, an asset or lien, that supports that kind of a——

Mr. **Kirkland**. That is correct, that is correct. I do not think the Tax Code should, when a company wants to remachine its production line——

Mr. **Guarini**. Or expand their plant.

Mr. **Kirkland** [continuing]. Or carry inventories, or a higher level of inventories, or service its accounts receivable——

Mr. **Guarini**. That would be legitimate tax deductibility.

Mr. **Kirkland**. And certainly, there is no moral reason why they should go to equity. That is perfectly normal and legitimate to borrow money for those purposes, and those debts are self-liquidating if they are prudently made.

However, the leveraged buyout debt is not self-liquidating without destructive effects on the company and its employees, and an enormous waste of money. We decry the shortage of savings in this country, and we are using billions and billions and billions of dollars of those savings from here and abroad for unproductive purposes.

Mr. GUARINI. Have you taken a position—if I may for my last question, Mr. Chairman, ask whether or not you believe, or have the unions taken a position on expensing out, that is, the full deductibility of any equipment—instead of having a depreciation schedule, to allow them to take off the first year, automobiles, machinery, instead of going over a period of 5, 7, or 10 years?

Mr. KIRKLAND. I would say offhand I would have to look at what the implications of that are for the revenue base in the current crunch.

Mr. GUARINI. Right. But the concept——

Mr. KIRKLAND. On merits aside from that, I am not yet ready to comment on it. But I have just been through for my sins a year's exercise on the National Economic Commission, examining the realities of the budget——

Mr. GUARINI. I understand it is terminally ill; is that right?

Mr. KIRKLAND [continuing]. And that makes me a little allergic to going for huge revenue losses.

Mr. GUARINI. I understand that. That has not been disbanded yet. I assume that you are still functioning.

Mr. KIRKLAND. Yes.

Mr. GUARINI. I thank you very much for your testimony, Mr. Kirkland. It is nice to see you again.

Mr. KIRKLAND. Nice to see you.

Mr. RANGEL. The Chair recognizes Mr. Levin, who yields to Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. President, I was struck, and I know you were in the room when Dr. Kaufman responded to Congressman Dorgan relative to the most recent takeover in North Dakota. And his response as best I can recall it, was that we can look for more of this to take place as the international marketplace becomes smaller and the opportunity exists for these takeovers. And, while we may not be in support of some of those takeovers, the fact of the matter is—and I believe Dr. Kaufman—I think they are going to continue——

Mr. KIRKLAND. So do we.

Mr. COYNE. I do not think we are getting much of a leadership commitment from the people in the administration relative to a remedy at this point; that may come later.

And I just wonder what your advice would be relative to making preparations for the dislocation that takes place—and it has taken place as a result of these mergers probably in every congressional district in the country—certainly in mine—where people are dislocated and put out of work by the mergers and takeovers. What is the AFL-CIO prepared to do to make the road a little bit smoother for those people who are displaced as a result of the takeovers? What are your recommendations to Congress for the immediate future, since we know that these mergers are going to continue to take place.

Mr. KIRKLAND. I think, absent action, they certainly will continue to take place, and it may get worse, because it is highly profitable. Some people make enormous amounts of money very quickly. And get-rich-quick has always been a rather attractive proposition.

So absent action, it certainly will continue. There is nothing to stop it, and there is everything to encourage its continuation.

You talk about the market, that the market will stop it—someone would have difficulty explaining to me just how. The market evaluated a firm's equity at a certain price. The junk bond aces come along, and all of a sudden, the market reevaluates it, and the raiding threat comes along, and the market reevaluates it at a difference price. What is the market price, and when was it ripe?

The market, many, many years ago, in olden times, valued Dutch tulip bulbs at an enormous price, but it was a balloon, there was nothing there—that market crashed. And that is a closer parallel to what is happening.

What troubles us, as you point out, is that when that bubble is pricked and it implodes, the people responsible for it are not going to pay for it. They will take the money and run. The innocents will suffer, and it will be our people and the people we are concerned about who will suffer, and American communities.

So I think it is urgent that this committee do its share of a larger job of trying, consistent with the kind of system that we like in this country, to bring these things to a prudent halt and work toward a circumstance where, when a company adds to its debt load or even its stock issues, it is for the purpose of creating added real investment value and improving that company's capacity to compete in the world. That is the issue at stake here.

We say that, well, not a all mergers and acquisitions are bad; I do not dispute that. There is a vast difference between the kind of mergers and acquisitions we used to see—some of them may have been haywire, and not all of them worked—but there was a great difference between those, which were usually accomplished, as I understand it—and I am not a financial expert—by the exchange of shares—equity—and raids on these companies by leveraged buyouts—debt, different in purposes, different in consequences.

Another negative aspect of the leveraged buyout craze is that the defensive measures are just as ruinous as the offensive measures. Talk about shaking up complacent management—somebody sent me a "Letter to Stockholders" by I think it was the Borden Company, expressing their concern about a possible hostile offer and attempted a takeover, and advising the stockholders that the 25 top executives of Borden had entered into a compact that if a hostile takeover which did not reflect their view of the long-term adequacy or value of the shares took place, they would quit, collectively, the top 25. That is the first instance that I know of of a managerial strike. But they seemed to regard that as a considerable poison pill. But I am sure they are all very well equipped with "parachutes".

But that is the sort of thing that is happening, and it would be very, very hard to explain to me how that is good for America or for the market system or for free enterprise or whatever else appeals to one.

Mr. COYNE. Thank you.

Mr. RANGEL. Mr. Levin.

Mr. LEVIN. Thank you.

With others, I welcome you and your associates.

You referred to the fees. I was reading Bob Rice's story in the Sunday Times Magazine, and I am all in favor of people making an honest buck or honest bucks. I was struck by his description of the fees in the Nabisco deal. He says, "The deal generated almost $1 billion in fees, an estimated $153 million in advisory fees, $294 million in financing fees for investment banks, and $325 million in commercial bank fees," and that lawyers fees were estimated to have run in the millions.

I do think we need to look at the extent to which the deals are being generated not by market forces so much as by other forces.

And one last quick point—it is lunchtime, and many of us were not aware we were going to be working through lunch. I will be very brief, because I need also to go for a bite.

This morning, we discussed the question, is there a serious question, and I think your continued interest and help on this will be invaluable, because again, I do not think Congress—this is my own judgment—is ready to act yet, because it is not clear enough that there is an issue that requires action. And until there is that kind of feeling within Congress and the Executive on a bipartisan basis, I am afraid we will stand on dead center while this whirlwind is occurring, for better or for worse.

Thank you, Mr. Chairman.

Mr. RANGEL. Mr. Dorgan may inquire.

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. Kirkland, thank you very much for appearing. Your compensation is less than $5 million per annum, I would expect.

Mr. KIRKLAND. Last time I looked, yes, sir.

Mr. DORGAN. I asked the question because I read a press statement the other day that indicated that someone who had worked for one of the major investment banking firms——

Mr. KIRKLAND. Unfortunately, my assets are in a savings and loan.

Mr. DORGAN. He had found that his salary, according to the press statement, had been cut from $18 million a year to $5 million a year, and his bonus had been frozen. His salary had been cut to $5 million a year.

Mr. KIRKLAND. It's one of life's tragedies.

Mr. DORGAN. That's right. Even as depressed as he must feel at being compensated at this $5 million level, my guess is that someone like him has a powerful incentive to believe in what he is doing and believe that the marketing of junk bonds, as he was involved in, is something that's very good and something that should not be stopped.

There's a propulsion behind what's happening that is very hard to stop. It is big, big money. It's the kind of money you and I have never dreamed of. And it's going on all over the country.

I spoke earlier this morning of a plant closing in North Dakota. In fact I was just on the phone again with the president of the company who had called. You, representing the head of the labor movement in this country, understand how important having a good work force is to having a successful business. If you don't have a good work force, you're just not going to do very well.

I was interested the other night in reading a Forbe's magazine interview with Harold Geneen. Harold Geneen accumulated probably 1,000 companies in his career. The title of the interview comes from Geneen's statement, "when everything's for sale, you lose something."

His point was that in this whole financial game, people have forgotten the value of the people that work in these companies. They actually make the company worthwhile. They've forgotten the commitment to those people. They've forgotten the determination those people use in their daily work life because they're committed to a company. And they've forgotten that if the company demonstrates it's not committed similarly to the worker, those workers are devastated. That's what's happening around this country today.

Can you describe what you see in the labor movement from that same perspective?

Mr. **Kirkland**. Things that common sense would tell you in those circumstances, sir, are exactly what's happening. I am entirely convinced, contrary to what some have said, that this thing is not taking care of itself. It will not only continue, but it will expand.

Two or three years ago, I was invited to give a lecture at a Swiss business school in Saint Gallen. And the audience was comprised primarily of European business executives and some academics and students. I talked about this problem of takeovers, buyouts, and its meaning and consequences as far as the dissipation of savings, the unproductive use of capital and the demolition of viable firms.

The reaction from that audience was that it was interesting, academically, but only the Yankees would do things like that. That is a purely American phenomenon.

Well, it isn't anymore. And they tell me that reprints of that are suddenly being in demand in Europe because those things are happening there and they are also coming from there to here to do it. So what we have here is an American phenomena, but perhaps in its inception is, like everything else in our economy, a global phenomenon.

Mr. **Dorgan**. My understanding is that hostile takeovers are virtually unheard of in Japan. Is that your understanding?

Mr. **Kirkland**. I believe so far, yes.

Mr. **Dorgan**. And it occurs to me that one of the reasons for that might be that the Japanese are culturally averse to allowing this sort of thing to happen and also understand that they would dissipate their economic strength if they did.

This would divert their attention from doing the things they should do to make better products and sell them at better prices instead of playing little monopoly games on the side.

My guess is that's why you don't have the kind of hostile takeover activity in Japan and in many western European countries that we have here. Is that your understanding?

Mr. **Kirkland**. I think that's probably true, sir. There is another aspect to the problem that you mentioned. This one not only has adverse economic effects directly in dollars and cents and jobs on the work force but the spirit of the work force has certainly got to be profound in this environment and the spirit is one of betrayed loyalty.

Getting to the point—in many, many areas it is at that point—the only people loyal to that company, in any real sense, are the workers because they're the only ones who give a damn whether it stays or not, or exists or not. Management is taken care of and there are roving adventurers with no roots of loyalty in that community. Only the people who have to live there and depend upon that for their livelihood have any real tangible sense of loyalty to that firm. And it's betrayed.

When I was going to sea for a living, and I was a ship's officer, we had a tradition—I presume it still exists—that the captain was the last to leave the ship.

In corporate America it seems to be just the reverse. And there is a special life boat padded in silk and satin for the captain to take off in. You can imagine the effect on the morale of a crew sailing under those conditions.

Mr. DORGAN. Mr. Chairman, if I can have another minute. Could you comment on the proposition offered by the takeover artists? I'm talking now about the financial folks who use junk bonds to seek opportunities for undervalued assets and launch a bid.

They say that they are doing America a service because so many middle-aged American corporations are run by slothful, indolent managers, staffed by workers that are not committed to their jobs. This supposedly represents a basic performance that would persuade the market to undervalue that company—at least, undervalue it relative to its potential.

So these takeover artists come and make a few changes. The market, which is supposed to be such a perfect mirror reflection of the underlying realities decides the potential was much greater with new management and new incentives to the workers.

Therefore, as Lewis Lowenstein said in his article, they compare themselves to the princess that kissed the toad and turned the toad into a prince. They say they make a lot of money and at the same time they really help American business and help America's workers and help America's economy. Your reaction?

Mr. KIRKLAND. The remarkable thing about that, and I've heard it, is that they can say it with a very straight face. In the first place, I do not believe it to be the driving motive in these adventures. They're not doing it out of a spirit of altruism in order to sharpen up America's competitiveness, they want to make a lot of money—fast—and that's why they do it.

Beyond that, I do not know what special expertise these junk bond specialists and takeover artists bring to the operation of any firm in almost any industry. We now have one of our unions, Food and Commercial Workers, and this has been a main target of takeovers—that industry—where a very high proportion of its members employed in that industry. Those remaining employed after all the shutdowns and layoffs, work not for people who know how to run or care or are interested or have experience in the management of retail stores, but by KKR who wouldn't be caught dead in K-Mart, much less a Safeway—never been inside one, perhaps, and after they make the money that they make out of it, they sure as hell are not going to go inside one. They'll send their butler.

They bring nothing, and that's the tragedy of it. They don't even bring the money to improve the process as a real tangible investment in an upgrading of competitive value.

Now who are they to judge that they are better managers of a retail establishment than the ones who are doing it? Maybe they are, but they don't know a damn thing about it and care less, and I think it highly unlikely that they do—or are.

I mentioned earlier—perhaps you weren't here—I said that in this argument, that they do a great service by shaking up decadent and tired and complacent, entrenched management.

It's not my trade to defend management, nor my inclination to any litany of the sins, I could add a few, having nothing to do with what these people are all about. I said ancient Rome was, no doubt, quite decadent, but its future prospects were not vastly improved by the restructuring imposed by the Vandals or the Visigoths and the Ostrogoths.

Mr. DORGAN. I did hear that. And I remembered it.

Mr. KIRKLAND. It wouldn't hurt to repeat it.

Mr. DORGAN. You just did.

Thank you very much Mr. Kirkland.

Mr. KIRKLAND. Thank you.

Mr. RANGEL. Thank you, Mr. Kirkland, for your testimony and the contribution that you made to this committee and the nation over the years. Before you leave, I would like to ask Mr. McGlotten whether he had any major differences to make at this point. [Laughter.]

Mr. McGLOTTEN. No, I do not.

[The following questions from Congressman Coyne, and responses, were subsequently received:]

Questions for Lane Kirkland
From William J. Coyne, M.C.

Question: When evaluating the desirability of a transaction, do you think it's appropriate to consider the impact of buyouts and mergers on groups such as employees and communities?

Answer: The AFL-CIO supports legislation that requires a corporation to inform both the workers and community of their plans for a restructured corporation. This has been a long held AFL-CIO position, and as you are aware, the Plant Notification Closing law is a part of this approach. We believe that an employer has a responsibility to both workers and their community.

Question: Would you support legislation that lengthened the amount of time elapsing between a company's being put "in play" and the ultimate consummation of the transaction?

Answer: We support an end to the "two-tier offer," an offer by which more money is given to one class of stock-holders as opposed to another. In addition, we have supported the extension of the time period between the offer and the time of purchase. This additional time would give stock-holders the ability to assess the economic consequences of a take-over offer and not be pressured by a "quick profit" motivation. In addition, we support legislation to require an acquirer to notify the SCC earlier of their intention to take over a corporation. All of these steps are designed to help the worker and the community understand the consequences of a take-over offer.

Question: Would you favor legislation that provides workers and local governments an opportunity to express their concern over a proposed takeover or acquisition?

Answer: We, of course, would support efforts that give a worker a voice in the takeover process. All too often, it is the long-time loyal worker who is the first victim of a debt-laden corporate structure. They are often the first to be fired or asked for "givebacks" to finance the new higher debt. You are to be commended for your legislative efforts for introducing the Communities and Job Protection Act of 1989. Your concern for workers and their communities is commendable.

Mr. **Rangel**. The next witness is Mr. William Olwell, executive vice president and director of the collective bargaining and negotiated benefits department of the United Food & Commercial Workers International Union.

Mr. Olwell, your full testimony will be entered into the record without objection and you could give your summary to us. We're glad that you were able to make it. We knew the difficulties that you had at the airport and we're glad that you are able to be with us this afternoon.

STATEMENT OF WILLIAM J. OLWELL, EXECUTIVE VICE PRESIDENT AND DIRECTOR, COLLECTIVE BARGAINING AND NEGOTIATED BENEFITS DEPARTMENT, UNITED FOOD & COMMERCIAL WORKERS INTERNATIONAL UNION, AFL-CIO AND CLC

Mr. **Olwell**. Thank you, Mr. Chairman, members of the Committee.

My name is William J. Olwell. I am executive vice president and director of collective bargaining and negotiated benefits department of the United Food & Commercial Workers International Union.

The UFCW has 1.3 million members organized in some 700 local unions throughout the United States and Canada. The UFCW and its local unions have collective bargaining agreements with tens of thousands of employers throughout the food industry, including retail sales, meat packing, food processing, leather, fur, health, shoe manufacturing and other industries.

Let me establish at the outset that the UFCW's area of expertise is not high finance. In the last several years, however, the UFCW was forced to take a crash course in the world of Wall Street. The UFCW and its members have learned, through a bitter and traumatic experience, how mergers and acquisitions and leveraged buyouts affect workers—changing their lives as well as their relationships with their employers.

While the newspaper headlines concentrate on the obscene profits of a few and the huge sums involved in megadeals, American workers have been the victims. The largest single cause of unemployment among retail workers in America in the past few years has been mergers and leveraged buyouts.

While economists wring their hands over the excessive debt financing these deals, American workers are losing productive jobs and buying power essential to a healthy economy.

In the last several years more than 400,000 UFCW members have been directly impacted by mergers and acquisitions and leveraged buyouts. Some 15,000 members have lost their jobs. Thousands more have suffered reduced wages and benefits as the price of keeping their jobs. The gains made by the UFCW and its members—in some cases, gains built up over 20 or 30 years of collective bargaining—have been destroyed in a matter of days. Wage rates, seniority, job protections have been sacrificed so that their debt-encumbered employers can keep the doors open.

It is important to remember that this happened to the members of a large, active and aggressive union. We have hired financial consultants, media experts, boycotted and picketed in a desperate attempt to protect our members' jobs and livelihoods. I hate to think what happens to members of unions of lesser means, or to employees of employers who have no unions to represent them.

UFCW members have borne the burden of megadeals that have failed, as well as those that were successful. The corporate restructuring necessitated by the huge debt incurred either by successfully fighting off an acquisition or by being taken over puts working people at risk. The first victims are those employed in the least profitable operations of a company. The company comes to the union and demands concessions from our members. The message is rarely subtle—concessions or else the division will be closed or sold. Often workers are asked to agree to concessions while management gives itself a raise or protects itself with "golden parachutes."

If a division is sold, the successor employer, under current labor law, has no requirement to keep the current employees or to recognize the union. Moreover, it is likely that a highly leveraged company will replay this scenario over and over again as massive debt service requirements squeeze operating revenues.

The UFCW's largest employer is now KKR. I want to repeat that. Our largest employer is now KKR.

A number of years ago we just knew them as a leverage buyout firm in New York and now their subsidiaries employ 13 percent of our 1.3 million members. This is a company that is not committed to a long-term operation in an industry. The "game plan" of most investment firms is to spin off assets and make a second round of profits by taking the company public again.

The implications for workers are ominous; the consequences real and tragic. Their jobs and their ability to share in the wealth which their labors create is their hope for the future. The problems caused by the current craze of mergers presents America with a problem potentially more devastating than the simple exploitation of America's workers for profit. The real threat is the destruction of the workers' attachment to their jobs and to work itself. Call it the dignity of work, if you will. Sacrificing the hard fought gains of workers in a real life game of Monopoly destroys the attachment workers have to their company's future.

UFCW members who have been harmed by this economic madness are mad at the old company, they're mad at the new company, they're mad at their union, and they're mad at their government for letting this happen. Those who have not yet suffered economically are scared that they will be next. Morale, productivity and commitment suffers—further undermining the stability and productivity of America's work force. Jeopardizing America's future productive capacity to benefit a select few economic royalists is at best shortsighted.

Where the UFCW continues to represent the workers in the new companies, we must begin again through the collective bargaining process to make up the economic losses. Making gains in the best of times is difficult. And, Mr. Chairman, despite rosy economic predictions, these are not the best of times in many areas of this country.

Mr. Chairman, we urge you and your colleagues to bring some equity to the process. Currently, the tax code unwisely encourages mergers, acquisitions and leveraged buyouts. Those who reap the benefits of these deals should begin to bear a commensurate share of the risk—rather than the Government and the workers. One does not have to be a financial wizard to understand that allowing the tax structure to underwrite get-rich-quick schemes that destroy jobs is self defeating.

We recognize the technical and political difficulties in attempting to deal with the problems of mergers and acquisitions and leveraged buyouts. The same Tax Code that now encourages job destruction must be made an instrument to protect jobs. The UFCW would like to offer the following as general suggestions for legislative changes:

One, prohibit any interest deductions unless there is an upfront cash commitment by the borrower of a percentage of the total to be borrowed. The cash amount should be similar to the margin requirement for the purchase of stocks.

Two, prohibit any interest deduction unless there is preferential hiring treatment for qualified nonsupervisory employees. Requiring new employers, under penalty of lost tax benefit, to give current employees a preferential hiring right or a right of first refusal on existing jobs—would restore some sanity to the process. Today, the risk of leveraged buyout is more often absorbed by non-beneficiaries—specifically the company's workers. Preferential hiring would provide them at least some job protection.

Mr. Chairman, I would point out that at that point of our testimony we really wanted to suggest that we put "successorship" into the leverage buyout operation. We just do not believe politically it is doable and we have backed up to this position and we think that if the Congress will seriously consider preferential hiring, a great deal will be done for employees of companies who find themselves in the situation.

Three, deny "golden parachutes" to top managers, while workers only have the "lead parachute" of unemployment. Much like the IRS non-discrimination rules on fringe benefits, employers who are part of a leverage buyout or corporate raid, should not be permitted to engaged in discriminatory practices concerning contingent severance benefits.

Mr. Chairman and members of the committee, I appreciate the opportunity to present the views of the UFCW. The UFCW looks forward to working with you in the coming weeks on your important legislative solutions to this critical and crucial financial issue.

Mr. RANGEL. Thank you, Mr. Olwell. I hope that you'll be able to furnish the committee with the specific data as to the loss of jobs and membership in connection with these mergers and acquisitions. I assume that you know the firms and the employees.

Mr. OLWELL. Yes, we will. We have a submission, in greater detail, backing up that statement I made here and it will be submitted to the full committee.

Mr. RANGEL. And it would help, too, if you could include in that, the best you can, the concessions that the union had to make, even with those employees that stayed on.

Mr. OLWELL. We'll be glad to do that.

Mr. RANGEL. And I assume that as it relates to the "golden parachutes," that you would have no problem if that included the nondiscriminatory clauses so that whatever benefits went to top management, it would have to be shared with workers at the lower level.

Mr. **Olwell**. We think that that would discourage an awful lot of this and make management maybe a little tougher in resisting some of these.

Mr. **Rangel**. Now, people will indicate that it's necessary for corporations to accumulate capital and that this is one way to do it. I assume that you have no way of limited dividends, taxes, or eliminating the so-called double taxation.

Have your people given you any views as to what we would do to substitute the subsidization of debt interest?

Mr. **Olwell**. We really haven't, Mr. Chairman. We really think that that probably is something that we're not expert in. We can tell you a couple of things, however. Let me use three examples—Safeway and Stop-and-Shop who were bought out, went from substantial taxpayers to nontaxpayers using large tax credits as a result of the buyouts. Kroger, who resisted and restructured, went from a taxpayer to a nontaxpayer because of the debt that they had picked up.

But more importantly to us, the capital that they previously used to expand their stores, must now go to pay the interest on their debt so that we get ourself in a double fix.

Companies don't have the capital to modernize; they don't have the capital to expand, and the only thing that's probably good for us in that aspect is that most of the major retail food stores in this country have undergone this process, so they're all in the same boat. We think eventually this capital shortage is going to put the survival of some of our existing companies in jeopardy.

Mr. **Rangel**. Well thank you, Mr. Olwell, and again we will keep the record open for that additional information for you to submit.

Mr. **Olwell**. Thank you, Mr. Chairman.

[The following was subsequently received:]

UFCW

February 16, 1989

Mr. Rob Leonard
Chief Counsel
Committee on House Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

Please find enclosed the corrected transcript of our testimony relating to the statement of Mr. William J. Olwell, Executive Vice President and Director of Collective Bargaining and Negotiated Benefits, before the Ways and Means Committee on February 1, 1989.

Representative Rangel requested additional data be submitted. Regarding job losses of UFCW members, Mr. Olwell stated that 15,000 UFCW members had lost their jobs as a result of LBO-generated activity. Our review of the data indicates slightly more than that number.

COMPANY	NUMBER OF JOBS LOST
SAFEWAY	9,500
LUCKY STORES	6,000
STOP & SHOP	3,000
GRAND UNION	2,000
	20,500

As regards Representative Rangel's request on concessions that stemmed from LBO activity, the experience of our Safeway members and those UFCW members who work in the same market areas will prove instructive.* Five Safeway regions, employing in excess of 25,000 UFCW members, or more that 25% of the total pre-LBO UFCW Safeway membership, were forced to take concessions to hold onto their jobs. In most instances, these concessions amounted to nearly $3.00 per hour, including wages and fringes. On an annual full time basis, that would amount to a direct transfer to the Company from its employees of nearly $160 million.

William H. Wynn
International
President

Jerry Menapace
International
Secretary-Treasurer

United Food & Commercial Workers
International Union, AFL-CIO & CLC
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However, an additional 42,000 UFCW retail food employees work directly in those affected Safeway market areas that underwent those concessions. In many instances, concessions were taken by those employees as their employers aggressively sought to keep wage parity with Safeway. Examples of this occurred in Arkansas, Texas, Kansas, and Colorado. (Most Utah employees have since lost their jobs as a second round of concessions apparently was not enough to keep the stores from closing).

Sincerely,

Michael L. Tiner
Director
Government Affairs

*See attachment

TO: TINER

FROM: HOWIE

RE: WAGE CONCESSIONS STEMING FROM LBO ACTIVITY

1. SAFEWAY
   A. OKLAHOMA - KANSAS - 5,000 EMPLOYEES

      WAGE RATES AND BENEFITS REDUCED $3 PER HOUR

   B. DENVER -- 6,400 EMPLOYEES

      1. WAGE RATES REDUCED $1.75
      2. PENSION, H & W, OVERTIME, NIGHT SHIFT PREMIUM, HOLDIDAYS, -- REDUCED.

   C. VIRGINIA -- 3,000 EMPLOYEES

      1. WAGE RATES REDUCED UP TO $2.71 PER HOUR
      2. HOLIDAYS AND VACATIONS REDUCED.

   D. HOUSTON -- 5,500 EMPLOYEES

      1. WAGES REDUCED UP TO $1.75 PER HOUR
      2. PENSION CONTRIBUTION AND VACATION SCHEDULE REDUCED.

   E. UTAH -- 3,100 EMPLOYEES (*)

      1. WAGES REDUCED UP TO $2.05 PER HOUR
      2. SUBSTANTIAL HOLIDAY AND VACATION CUTS

   (*) THIS DISVISION HAS SUBSUEQUENTLY CLOSED; MOST EMPLOYEES ARE NOW JOBLESS, THE REMAINDER ARE WORKING IN NON-UNION JOBS AT FAR INFERIOR RATES AND BENEFITS.

   F. ARKANSAS -- 2,400 EMPLOYEES

      WAGE AND BENEFIT REDUCTIONS OF $2.64 PER HOUR.

SAFEWAY SUMMARY

25,400 OR 25% OF UFCW REPRESENTED SAFEWAY EMPLOYEES TOOK DIRECT AND IMMEDIATE WAGE AND BENEFIT CUTS. AS A RESULT OF THE LBO.

42,400 ADDITIONAL EMPLOYEES, WHO ARE UFCW REPRESENTED FOOD STORE EMPLOYEES WORK IN THE SAME MARKET AREAS AS THOSE SAFEWAY EMPLOYEES. THEY ARE INDIRECTLY AFFECTED AS AND BENEFIT CONCESSION PRESSURES HAVE FORCED UPON THEM AS A RESULT OF THOSE GRANTED IN THE SAFEWAY LBO.

Mr. **Rangel**. The Chair would like to announce that the next panel was advised to appear at 2 p.m., but if they are here, we are prepared to proceed. Is the Honorable Michael Blumenthal with us now?

[No response.]

Mr. **Rangel**. Well, if the panel is not here, then the Chair will recess until 2 p.m.

AFTERNOON SESSION

Chairman **Rostenkowski**. Welcome to the committee, Mr. Blumenthal and Mr. Ball. Because of your time constraints, I would like to have you testify, and if it is all right with you, Mr. Ball, we will go through the question period with Mr. Blumenthal and then we will have your testimony and then have some colloquy with you.

First of all, let me just say, Mike, it is always nice to see you. We go back a little while. We were in the woods together a couple of times at the White House. I really appreciate the fact that both of you are sharing this time with us. I am sure that you can help us immeasurably in the very delicate situation that we find ourselves in. I think that there is an understanding here on the part of every member of the committee that we know it is a sensitive area. We certainly do not want to do anything that is going to encourage a downturn. We do not even know whether or not we should legislate in the area. But by gathering the information from experts such as you, I think that at the conclusion of these hearings we will be able to make a determination as to just what direction we will go. And I do not mean to say that the Ways and Means Committee is going to be an independent operator. We are looking for the department as well to work with us in framing the legislation if legislation is necessary.

Having said that, Mike, you may start with your testimony.

STATEMENT OF HON. W. MICHAEL BLUMENTHAL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, UNISYS CORP. (FORMER SECRETARY OF THE TREASURY)

Mr. **Blumenthal**. Thank you very much, Mr. Chairman and gentlemen. May I say also, Mr. Chairman, that I am happy to be here and to have the opportunity to speak on this important subject. It does indeed bring back old memories, many of them pleasant, some of them not entirely pleasant.

I welcome the opportunity to talk on this subject. I will not read, of course, my statement, which I have submitted to the committee. I would like to briefly summarize it.

The principal focus of this whole subject as I see it is the impact on the functioning of the overall U.S. economy with particular reference to productivity and our international competitiveness. We really have to ask ourselves the question, do LBO's do leverage and the trend toward increased leverage—have a positive or negative impact on these factors?

I think there are a few elements of caution, as the committee considers whether legislation is required, that are very important at the outset. First, wherever possible, we ought to leave the market to do its work, to leave the market to its own devices. It is extremely difficult to figure out exactly how to interfere in the free functioning of the market. The least interference is the best in this area, as far as I am concerned.

Second, restructurings, many buyouts, acquisitions, and some leveraged buyouts are to the good. There is nothing wrong with these things in principle. There are a few which are potentially, in my view, inimical in terms of their impact on the U.S. economy. The problem is that it is very hard to distinguish between the good ones and the not so good ones. But that does not mean that one should not try. And I have suggested in my testimony that it is important to understand which ones give concern and that it is possible to deal with those.

Which are the ones, then, that I would be concerned about? I am primarily concerned about, and I suggest in my testimony that we ought to worry about, those LBO's where virtually all of the equity is replaced by high-cost debt and where, as a result, the coverage of cash flow over interest cost is razor thin, with that ratio only narrowly over one point zero times one of the other, under favorable conditions. And we have not yet gone through a situation, and hopefully we will not but we may, in which there is an economic downturn. But even under good conditions, the best of the conditions, cash flow barely covers interest cost.

These situations have some general characteristics. They tend to use the very highest-cost junk bond debt; 16, 18 percent debt, very expensive at the margin. They even use these famous PIK's, the payment in kind type of security, where interest is not even being paid in cash, just with additional pieces of paper that further put at risk, in my view, the financial structure of the enterprise. They tend, not always, but they tend at times, to be management buyouts, and that has some special elements. And they tend frequently to be of a kind where it is very difficult to see the underlying industrial purpose; in fact, one has to conclude that their purpose is fundamentally a financial one and that the deal itself is motivated more by the promoters than by any long-term rhyme or reason. It is exactly that kind of thing that gives cause for the greatest concern.

I have, on some of the boards on which I have served, Mr. Chairman, witnessed the famous blue book syndrome, where some of the promoters will come to the management and will say: you know, you ought to restructure; you know, you ought to consider an LBO; and here is what you can do; and here is how you can pay out a lot of money to the shareholders and everybody will be happy, including the lawyers and the bankers.

When the management says they are not interested, they then will shop the blue book to others until somebody is willing to mount a raid on that company. Then the fat is in the fire, and you get into a competitive situation of who can lever the company the most and pay out the most. It is that kind of situation, I think, that has some potentially inimical implications.

I will not go through all the reasons, although they are in my statement. But there is a risk of increased bankruptcies. It may increase the exposure of commercial banks in those situations where bridge loans are involved. It may affect the efficacy of fiscal and monetary policy. It may put the Fed between a rock and a hard place because the use of monetary policy becomes more dangerous if leverage becomes widespread. And fundamentally it costs the Treasury money because debt is substituted for equity and the resulting interest costs are deductible. Perhaps not in the short run—I think there has been some testimony in the past that in the short run it may not—but certainly over any larger period of time the cost to the Treasury is obvious. And I think the calculations would indicate that.

The key implication of those kinds of deals is that cash becomes key, and that the short-term horizon becomes key. Anyone who tells you that that is not so is really not telling you the truth.

In these kinds of situations everything must be done to maximize all sources of cash. Any kind of longer run horizon has to play second fiddle to that. It is a little bit like a politician who is told about some desirable long-run policy but who tells you, and I have heard it said to me: yes, but I have got to get elected first, and I cannot afford to think about wise policies if I am not around after November.

It is the same thing for the CEO. You tell him it makes sense over 3 or 4 years to make the enterprise more efficient and to invest money, and he will say: yes, but I have got to be here first; I have got to feed the bankers first; and that is now job number one.

These kinds of situations must be distinguished from those buyouts and acquisitions where there is a genuine industrial purpose. I will not take the time to contrast these situations at length. that with the case of my own company, Unisys, the result of putting Burroughs and Sperry together in a genuine industrial merger. But that was very different. We used fundamentally conservative sources of financing. There was a major restructuring in the industry. The results are clear for all to see. That is very, very different, and I really think the case of Unisys demonstrates that distinction.

Finally, what should the possible responses be to the current situation? As I say, we want to be careful not to discourage productive mergers and desirable restructurings. I think, clearly, and this does bring back old memories, Mr. Chairman, that the disparate treatment of debt and equity is something that the committee ought to look at. We frequently before this committee talked about the double taxation of dividends. I recognize that eliminating it is a difficult thing to do, particularly because of the revenue loss. But I would think that, as a long-term goal, eliminating gradually this artificial disparity would be an important thing for you to consider. It is an artificial incentive to borrow. It makes the government a partner in a way in which you do not want to be a partner.

It is different from what any other country does, as far as I am concerned, and in a more global economy it is important to try to get that behind us.

The second element, apart from this disparate treatment of debt and equity, I think, is to focus on certain types of financing devices. And I would say the junkiest of the junk bonds are the ones that we ought to focus on, in particular the payments-in-kind bonds that I have talked about.

The Treasury today already has some powers to reclassify debt as equity, and under the capitalization rules, to issue some further *regulations. I think that ought to be encouraged.*

The Treasury, third, could build on another existing power, and that has to do with the fact that while interest is recognized as a legitimate business expense, the code already defines some circumstances in which deductibility can be curtailed. So that is not creating a precedent. I would say whether that applies to investments with passive interests, or other types of purposes, this could be extended to some of these instruments at the margin.

Fourth, I would have to mention capital gains taxation as being, pretty much in the same category as the difference between taxing dividends and interest. Somehow taking into account the length of the time that an asset is held and making it less attractive for the arbitrageurs to take advantage of these situations, I think, is something we ought to look at.

I would also mention limiting the use of funds from certain sources. Again, most of these can be handled through regulation. I think the Fed needs to be very careful about making sure that commercial banks do not extend bridge loans to unwise situations or do not overextend themselves. I think that in Government insured or guaranteed funds, whether they are pension funds, S&L's, or whatever, that there are clearly the possibilities that the SEC, the FDIC, or the PBGB under ERISA, can review the rules to make sure that those resources are not misused in cases where eventually the taxpayer has to pick up the tab.

Finally, two other quick points. First, in the case of the management led LBO's, the SEC could deal with these by regulation. I think there needs to be fuller disclosure than we have had and adequate time for competing bids to come forth. I would think regulation is by far the best and preferable approach over legislation.

Second, I would have to end, Mr. Chairman, by saying that there are some situations where I think that somewhat more resort to the antitrust laws might also be worthwhile. We sort of suspended them in the past.

Chairman ROSTENKOWSKI. I think the Judiciary Committee is going to look at that, Mike.

Mr. BLUMENTHAL. That is a very quick summary of my views. I will be glad to take whatever questions you may have.

[The statement of Mr. Blumenthal follows:]

STATEMENT OF W. MICHAEL BLUMENTHAL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, UNISYS CORPORATION

I am pleased to appear before this Committee to discuss the recent increase in corporate restructurings and, specifically, leveraged buy-outs (LBOs) and their implications for the economy.

Recent years have seen an increase in the trend towards corporate restructurings, including buyouts, mergers, acquisitions, takeovers, and LBOs. The proper perspective for evaluating these activities is their long-term implications for the productivity of the U.S. economy and its global competitiveness.

Many factors, of course, influence this competitiveness, the most important of which is the U.S. federal budget deficit. Reducing our deficit and the global borrowing it demands must remain the Congress' first priority.

But corporate restructurings can also have an important effect on our competitiveness, both for good and for bad. We must therefore exercise extreme care in distinguishing among the different types of restructurings in this regard. Our goal must be to identify and address those that tend to reduce our competitiveness while not impeding the gains that can be achieved through responsible and forward-looking mergers, acquisitions, and restructurings. This committee should see the role of fiscal policy in that context.

In summary, therefore, I would make three major points;

- first, that corporate restructurings have the potential to contribute to productivity, growth, and competitiveness and that we should, to the maximum extent consistent with our economic goals, allow the market to work in this regard;
- second, that the potentially most inimical restructurings are LBOs where virtually all equity is replaced by high-cost debt, leaving the cash flow coverage of interest at levels too narrowly above 1.0 and imperiling the corporation's ability to survive in the long-term. These LBOs frequently are the result of financial manipulations for short-term gains but without any identifiable industrial purpose in mind; and
- third, that the trend towards this kind of unwise debt may have been facilitated in part by the tax structure and by the recent financial evolution of certain types of "junk bonds," and that adjusting our tax and regulatory systems to address these factors would facilitate the legitimate workings of the free market rather than restrict them.

The Implications of LBOs

This Committee's concern with the substantial growth in leveraging in corporate America is correct, as is its assessment that this leveraging could have substantial implications for the way our economy behaves. First, excessive leveraging could leave us more vulnerable to a recession or economic downturn. In the first five years of this recovery (1982-87), corporate credit market debt increased by 72 percent, in contrast to a 42 percent increase in GNP. Much of this increase in debt has come at the expense of equity; between 1984 and 1988, non-financial institutions have increased their debt by over $900 billion while retiring about half that amount in equity. As a result, net interest payments have risen, as a percentage of cash flow, to about 25 percent, a level associated only with the depths of recessions, when cash flows are leaner and interest rates higher.

If leveraging increases the risk of corporate bankruptcies, then it would make the severity of a possible future recession yet greater. A recent study noted that, if the recession of 1973-74 were to occur again today, then 10 percent of a sample of U.S. firms under investigation would be bankrupted -- and this sample was weighted towards older, more mature firms that may carry less debt than their younger, smaller, counterparts.[1]

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[1] Ben S. Bernanke and John Y. Campbell, "Is There A Corporate Debt Crisis?," in Brookings Papers on Economic Activity, 1988, I, pp. 83-125.

Our financial system may also be exposed to this risk if commercial banks yield to the temptation to use too much LBO financing to maintain their profitability. As of late 1987, there was already some evidence that some money-center banks were holding growing proportions of their stockholders' equity in the form of LBO loans. This suggests that the soundness of our financial institutions could be placed in jeopardy if a recession or changed market conditions were to push highly leveraged firms into bankruptcy.

Leveraging is also significant in the struggle against inflation. First, greater leveraging makes interest expenses a more important cost of doing business. Thus, higher interest rates may not "cool off" short-term price increases in the manner we hold them to if we have a more leveraged economy. Highly-leveraged businesses may try to pass their higher interest costs to the consumer as they struggle to survive in a tight-money environment. Leveraging may, therefore, lead monetary policy to have short-run effects opposite those intended.

Moreover, the Fed itself may have to change its attitudes towards inflation if the corporate sector becomes over-leveraged and, therefore, vulnerable. Chairman Greenspan may find that, due to excessive leverage, the interest rates needed to slow inflation would also put more firms in danger. Thus, leveraging may compromise the Fed's ability to fight inflation.

Leveraging also has implications for the federal budget. Immediately, leveraging substitutes deductible interest payments for taxable — in fact, doubly taxed — dividends. Beyond this loss of revenue, the federal government has become a silent partner in the LBO wave due to the purchase of high-yield, LBO securities by banks and pension funds that carry federal insurance or other guarantees. Thus the federal government has become an unwittingly but important player in the trend towards greater corporate leverage.

But the most important effect of corporate leveraging may be its possible compromising effect on our nation's productivity and, in turn, its international competitiveness. President Bush has already directed his economic policymakers to develop proposals that would guide U.S. corporate management towards these long-term goals. But the potential abuse of leverage may exacerbate the tendency towards short-term profits at the expense of long-term performance. The most heavily-leveraged firms are less likely to be able to conduct R&D, to invest in new plant and equipment, to develop new products, or to otherwise take a long-term perspective when responding to the challenges of international competition.

Excessive leveraging, therefore, must be considered in the light of the U.S. trade deficit and the need to reorient our economy towards international markets. The heavy international debts our economy accumulated in the 1980s can only be repaid if we succeed at becoming better innovators, producers, and exporters. By the middle of the next decade, our exports will have to cover not only our sizable merchandise imports, but as much as $100 billion in debt service as well. If American industry must devote ever growing shares of its profits and cash flow to servicing its debts, then it is far less likely to meet this challenge.

The Proper Role of Mergers and Acquisitions

With these concerns in mind, our principal focus should be on those LBOs that have left their firms with "razor-thin" levels of interest coverage for fixed debt, for it is here that buy-outs appear to have financial, rather than industrial, purposes. Moreover, large pools of funds exist for the express purpose of financing prospective LBO deals that could lead more corporations into this circumstance.

The existence of ready money through "junk bond" financing has created a discontinuity of risks and gains. Bankers, financiers, and lawyers receive their large fees up front in exchange for leaving more heavily leveraged and therefore vulnerable corporations behind. Where once mergers and acquisitions were part of a company's strategy to achieve growth, we now have among us a new class of economic agent whose sole function is to put corporations "into play" — in short, deals are now being made for their own sake.

The resulting asymmetry of risk and reward is even more pronounced for management buy-outs. In these instances, managers can produce sizable gains for themselves while bearing very little risk as individuals. The risks they create through excessive leveraging and its attendant problems are borne elsewhere -- by workers and their communities, by bondholders, and by the nation as a whole. The short-run orientation that management must take in this situation leads to potential gains for a few, but long-term risks and losses for the many.

The defenders of leveraging -- including the management that use it to take their companies private -- have put forward a variety of rationales for their activities. Some of these arguments have merit, but some tend to be self-serving rationalizations advanced to defend an interest in the gains to be made in the process. For example, proponents note that debt-to-equity ratios are even higher -- often far higher -- in our industrial competitors than in the United States. But this argument fails to note the significant institutional differences among the industrialized economies. Most significantly, both banks and governments bear part of the risks that in the United States are borne by businesses.

In West Germany, for example, banks own about 15 percent of all corporate equities and commonly sit on the boards of directors of the companies in which they own a stake. In Japan, companies are often held by conglomerate groups that include, if not revolve around, a major bank. This closer relationship lowers the risk of leverage, but at the same time requires that banks infuse new money into companies that are struggling. Moreover, the risk of heavy corporate debt is lowered in these nations by sanctioning a level of concentration of economic power that our system has traditionally disallowed.

There is also the argument that the threat of acquisition forces a new discipline on entrenched and lethargic managers. Some studies have identified some increase in the profitability of acquired companies, although this effect is a short-term one and, even here, the evidence is mixed.

The fact that some firms improve their performance after acquisition is undeniable. But it is not a persuasive argument for the most heavily-levered LBOs. Our economy has traditionally relied on competition in product markets to discipline and reward management. If anything, this discipline has intensified in recent years owing to the globalization of product markets. In fact, the success of many of our basic industries in retrenching and reemerging as effective competitors can be ascribed to the fact that they were not candidates of takeovers and were not forced to lever themselves and, therefore, had the resources to invest in modernizing their plants and updating their products. If LBO practitioners were truly adept at their claimed ability to create value where before there was none, we would expect to find their activity disproportionately centered in those industries undergoing adjustment. Instead, we find them concentrated recently in the consumer goods field, where brand names offer greater protection from international competition and the business cycle.

None of this is to deny that certain types of corporate restructuring can improve the long-term competitiveness of the firm. Our economic history offers many cases where well thought-out and conservatively-planned mergers and acquisitions with industrial purposes as their goal played an important and productive role. I understand from my own experience -- the creation of Unisys out of the merger of Burroughs and Sperry Corporations -- that mergers may allow synergies in production, marketing, management, or research that leave the merged firm a more effective competitor than its predecessors. But this kind of merger can be readily differentiated from certain types of LBO deals by its clear industrial purpose. Moreover, as was true in our case, this kind of merger rarely utilizes the riskier kinds of junk bond financing. Unisys found itself, two years after the merger, with a debt-to-equity ratio no higher than that of Burroughs before the merger. The research, manufacturing, and marketing aspects of our business have all become more effective after eliminating duplication between the two predecessor firms. In short, the Burroughs-Sperry merger was guided by a long-term plan aimed at improving productivity and competitiveness. This type of combination should be contrasted to deals at the other extreme, where the resulting company is endowed with a pyramid of debt and interest coverage ratios barely over 1.0 during a period of economic expansion.

Policy Responses to the LBO Wave

The problem, then, is not mergers per se, but the environment in which they occur and the aims and goals to which they are applied. The challenge to the Congress, therefore, is to design policy responses that do not obstruct productive mergers but discourage unproductive and often self-serving leveraging that weakens the country's financial structure and impairs our international competitiveness. This is a difficult task. The facts need to be reviewed carefully and hasty action should be avoided. Some additional legislation maybe needed but for many purposes, regulatory changes maybe the best approach. I am glad to note that Secretary Brady, in his testimony before this committee last week, discussed several productive proposals in this regard. I am in support of many of these ideas.

A first step lies in redressing the disparate treatment of debt and equity in the corporate income tax, an important long-term policy goal. Interest expenses are, of course, deductible, while dividends are taxed doubly -- first as corporate income, and then as the personal income of stockholders. This creates strong incentives to substitute tax-subsidized debt for tax-penalized equity. This situation could be corrected by eliminating the double taxation of dividends. It should be noted, however, that the revenue loss associated with completely eliminating double taxation would amount to roughly $40 billion annually; this loss would have to be balanced with other changes in the tax code that recovered these revenues. There is obviously also the opportunity for phasing in the needed changes.

The different tax treatment of equity and debt relates to the second factor behind the recent increase in LBO activity — junk bonds. Some types of junk bonds — for example, "payment in kind" bonds or "PIKs," in which interest is paid in the form of yet more bonds — in many ways resemble equity more than they do debt. PIKs strike me as undesirable in most instances. By issuing unsecured paper, they progressively weaken the capital structure of a firm. As the riskiest security, they are the most suspect form of financing of all.

An approach towards rectifying the imbalance between the tax treatments of debt and equity, therefore, could lie in the Treasury Department's regulations concerning this type of security. The Treasury now has the authority to reclassify a debt instrument as an equity if it exhibits those characteristics. The Administration should now consider instructing the Treasury to promulgate regulations on this matter and begin to enforce them. Alternatively, the Congress might wish to provide the Treasury with legislation that makes clear the distinction between what is debt and what is equity.

We may also wish to consider limiting the deductibility of interest expenses on certain types of high-risk junk securities beyond a certain point. While interest is a legitimate business expense, the tax code already defines some circumstances in which its deductibility may be legitimately curtailed, as it does for investments with a passive interest. These limitations must be considered carefully, however, since foreign firms would continue to enjoy interest deductibility and therefore would enjoy an undue advantage over U.S. firms in the acquisitions market.

A further needed change in the tax code would tailor the capital gains rate to the length of time that assets are held. Much of the attraction of LBOs is the opportunity they offer to turn over an acquired company's stock quickly. Time-based capital gains rates would discourage this speculation and encourage investors to adopt a more long-term time horizon when making investments. It could also limit the incentives for stock arbitrageurs to enter the market for a company's equities once the company is "in play," thereby putting upward pressure on the stock price and adding to the need for leverage to complete the acquisition.

We must also reappraise the way in which we regulate the banks and pension funds that purchase the securities of leveraged firms in order to limit the use of fiduciary funds in leveraging. The FDIC and the Comptroller of the Currency must press banks with higher exposures to LBO loans to build their loss reserves or to raise their capital above minimum working requirements. The Congress may wish to limit the participation of pension funds and ESOPs in the market for these securities given the tax and insurance benefits provided to these entities by the federal government. The Federal Reserve could also impose separate, higher margin requirements for loans that will be secured by the future purchase of equities, since they carry a higher level of risk. These steps would be appropriate given the federal government's contingent liability for bank deposits and pensions.

Some changes regulating management-led LBOs may also be desirable. To avoid the obvious potential for conflicts of interest and abuse, there must be a careful review of the rules governing disclosure of all relevant facts to the public and for ample time to be provided for alternative bidders to come forth.

Finally, the concentration of LBO deals in a few specific industries -- notably such consumer products as food and beverage -- also suggests that proposed acquisitions could receive somewhat more rigorous scrutiny from anti-trust regulators than has recently been the case.

Chairman **Rostenkowski**. For the purpose of enlightening my colleagues, Mr. Blumenthal is going to have to leave in a short while, and therefore Mr. Ball has agreed not to testify until after we have concluded with Mr. Blumenthal.

You pointed out that it is a very sensitive area; you have dealmakers and shoppers and you have a healthy company that does not want to participate in the buyout. How do you differentiate? How do you use the surgery that we have put into law as opposed to the sledge hammer? What is it that we can do that keeps the viability, that keeps the genius of the American businessman, the entrepreneur? How do we protect the honest businessman who wants to build a company that does not have the fat in it? If we could solve that problem, I think that is what we want to do.

Mr. **Blumenthal**. I think there are a number of ways you can approach it. First of all, you can deal with, I would say, potential abuses, or potential unfairness; I think that is a better word than abuse. For example, it is certainly possible, and in my view it has happened, that in some management-led LBO's there has been a conflict of interests. The inside knowledge that management has had has been used to take advantage of the shareholder. You could, with disclosure requirements and enough time elapsing, deal with that kind of situation.

Second, it seems to me you could focus on the instruments, the financing instruments involved. I refer to the fact that the LBO's that worry me are those where the coverage is really razor thin. As Mr. Ball reminded me before we started, he has even seen some where it is negative. I asked him how that is possible. He will explain that to you. I guess he was saying to me that they come to him and they show him some where they say: oh, we will fix that up later somehow; we will just reduce costs some more.

Those situations normally, as I have said, Mr. Chairman, are characterized by certain types of instruments: 18 percent debt, PIK's, that type of thing. I think that there is a way to put some limits on them through tax changes and through regulation or a combination of the two.

Chairman **Rostenkowski**. Mr. Pickle.

Mr. **Pickle**. Mike, it is good to see you again. We remember with appreciation the great contribution you made to our government. We thank you for being with us again today.

I pose this general question. It seems to me that the villain in this whole problem is the amount of interest that is deducted. You do not say much about it except you do say that we could have some limitation on interest.

Everybody who has appeared from the financial market has said we ought to do away with this double taxation on dividends, and they are all for that. But we cannot give that up unless we do something about interest, because of revenue. Now, how do we handle that?

Nobody seems to give us a good clear answer on that. I could not get that from the Treasury. Maybe we will later, because we need very much to have their help on it. Now, what can we do about interest? You do not get into that, but I just ask the broad question.

It seems to me that interest should be deducted to a certain extent, and I propose a 50-percent deduction and, a 50-percent deduction on the dividend. But I do not know whether it would be 20 percent or 50 percent. Both the Joint Tax Committee and the Treasury ought to be able to tell us the figure.

Let me tell you, it seems to me that some of the interest is going sky high through junk bonds and other categories, way out of markets. It is not just 1 or 2 points above the norm, but some pay up to 5, 10, 15 percent. Now, at some point, Mr. Secretary, some of that debt is really equity; not interest. And that is what is running this whole business.

It seems to me like we ought to tackle that. Now, how can we do that?

Mr. BLUMENTHAL. First, of all, I sympathize with Secretary Brady because it is a difficult problem, as you yourself have pointed out, and one has to be very careful. I do not think it is impossible to define some circumstances beyond which what is called interest really is not interest in the way in which the Congress originally intended it for purposes of deductibility. For example, you could define some circumstances where the borrowing procedure used for the purpose of repurchasing your own shares, not for productive purpose, and where the cost at the margin is extraordinarily high. I think the combination of the cost over market and the purpose for which it is used provides some opportunity for the Treasury to promulgate some rules.

I know that the implementation of that has been very difficult for the Treasury, but I think we are in a situation where they ought to be encouraged to go back and to try to define something more clearly in that area.

Mr. PICKLE. Well, it seemed to me like we have got to establish some kind of a base, and say this amount is deductible. And anything above that is not deductible interest. Now, how we arrive at that is our problem. I think we have got to reach that point.

Mr. BLUMENTHAL. I agree.

Chairman ROSTENKOWSKI. Mr. Guarini.

Mr. GUARINI. It is nice to see you, Mike, again after all these years. In your days you just had to worry about oil shocks. Now we worry about savings and loans, banks, LBOs, and trade and budget deficits. But then again maybe, as the French say, the more things change the more they remain the same.

In regard to the question that Jake just asked, should interest in your mind be limited to perhaps incorporations where they have secured liens, first liens, mortgages, R&D loans that are made for research and development, and not have subordinated, which would be LBO junk bonds, loans where there are no assets that are secured by the loan? Could we, in your experience, differentiate between two kinds of interest, one that would be good for the expansion and growth of an industry or a company, and the other that would be more in the line of an unsecured debt that would be in the vein of a junk bond?

Could we differentiate, in your mind?

Mr. BLUMENTHAL. I really think you are getting into very difficult territory. I think people would be able to find their way around that, however tight the definition would be. And I do not really think that that is productive.

I think the approach that I have suggested, which is that you take certain type of instruments and put some limits on the deductibility of interest there, or redefine what portion of the interest is really in the nature of more like a dividend——

Mr. GUARINI. Or have a floating rate cap so that you have no more than four points above prime, or whatever, so that you know that the equity holders are not going to be watered down any more than they should be?

Mr. BLUMENTHAL. I think that may be possible for certain types of instruments, but the more general rule that you have suggested, I think, would be extremely difficult.

Mr. GUARINI. Because we know people with green shades that stay up late at night and think around anything that we may put together in a tax code, and it is not very hard. It has been proven to be so.

When Mr. Kirkland testified, he said we should do more to tax greenmail and golden parachutes. Do you have any opinion on that? And he also added that he did not think that any LBO's were valid because he has yet to see where they have created work, they have put workers out of their employment, including management. And although some acquisitions do make sense and bring efficiency, progress and help to rebuild the future, still that is with mergers and acquisitions. But LBO's is a question in labor's mind of whether or not any of them are any good.

I just thought maybe you could comment on that.

Mr. BLUMENTHAL. Well, I have a great deal of respect for Lane Kirkland, but I would disagree with that statement. I would caution you against overgeneralizing in this area and saying that LBO's per se are bad. There are many, many legitimate reasons why a company in our free market system may wish to go private and may wish to use leverage. There are lots of young, growing companies where considerable leverage is desirable and where this is a perfectly legitimate and, in fact, positive technique.

Finally, I would say, I do not know whether you want me to comment on greenmail or on golden parachutes. I think greenmail is reprehensible but I do not know whether legislation will deal with it. Again, it is going to be very difficult to distinguish in the code what is legitimate income and what is a golden parachute payment. It is not going to be easy to do.

Mr. GUARINI. Lastly, let me ask you, were you Secretary of the Treasury when we were putting through expensing out? Did you have an opinion on that, where we could write off, instead of having depreciation tables for automobiles and machinery, et cetera, they would be able to expense it out all in one year? Did you have any opinion on that?

Mr. BLUMENTHAL. I think that was subsequent to my tenure.

Mr. GUARINI. Thank you. It is nice to see you again, sir.

Chairman ROSTENKOWSKI. Mrs. Kennelly.

Mrs. KENNELLY. Thank you.

Mr. Blumenthal, yesterday Secretary of the Treasury Brady seemed to say that he thought it was too early to do anything about LBO's, that we did not know if the activity might calm down, and that the big, big takeovers may be over and we will not see any more of them. In your testimony today you, at the end, gave us some suggestions of actions we could take, and possibly along the regulation route, such as getting rid of some of the worst junk bonds.

My question to you: since the Secretary of the Treasury does not really feel we should do anything now, and of course the Treasury would have to move to get these regulations issued, what do you think would be worse? Would it be worse for us to do nothing and possibly find ourselves faced with a debacle like the S&L's in 1 year or 2, or should we legislate and attempt to put some kind of a cap on the activity that we are seeing today and that we are worried about?

Mr. BLUMENTHAL. First of all, I say in my testimony that I agree with much of what Secretary Brady has said. I read his testimony before the Senate Finance Committee. I did not see his testimony yesterday before this committee, but I doubt that it is much different. So, I agree with much of what he said.

I would go just a bit further than he. I would say that, while I understand that the easiest thing is to do nothing, and while it is true that we have been fortunate—and I hope that it will continue—that we have had good economic times and no significant difficulty has occurred, these kinds of situations have not been tested by adverse economic circumstances.

I just wish that we would have the courage to move before there is trouble rather than in response to trouble.

So I would say that I would go just a bit further and hope that the Treasury will look at what it can do with the powers that it already has. My impression is that they are really doing that. But, if I may be so bold as to suggest it, I hope that this committee will encourage the Secretary to do that on an accelerated basis and not just say, well, it is not time yet really to work on that.

Second, we should insure that the other agencies—the SEC, the FDIC, PBGC, and these other various agencies—do their job, and then I look at whether or not, in the light of what they are willing to do, it is necessary at this point to have some legislation or some changes dealing with the tax matters that we have just referred to.

Mrs. KENNELLY. Could I just take it one step further? Would that "little" bit further be satisfied if the administration or the Treasury right now really took a positive stance and stated they would use what they already can do, to say define the difference between debt and equity? They have that ability, as we all know, right now. If they went right out front and said: Now, we are going to take positive action on this; do you think that that would be that little bit that you think should be done?

Mr. BLUMENTHAL. If that could be done, if they were willing to do that, and the definition would look reasonable, I think that would be a big step forward. I think then I would be a little more comfortable in saying, well, let us see how that works out.

Mrs. KENNELLY. Thank you.

Chairman ROSTENKOWSKI. Mr. Chandler.

Mr. CHANDLER. Thank you, Mr. Chairman.

I was intrigued by the article in the Wall Street Journal today about Phillips Petroleum. I do not know if you have had a chance to see it yet. It is my judgment after reading that article that in this case a company that has been able to avoid two takeover threats and now perhaps faces a third, has actually become a healthier company than it was before.

Is that your judgment? Is that also happening as a result of this leveraged buyout or takeover kind of phenomenon?

Mr. BLUMENTHAL. Absolutely.

I cannot tell you anything about Phillips. I am not at all acquainted with that situation. My knowledge is no greater than reading the newspaper, as you indicated. But I said at the outset of my remarks that one has to be very careful in this area. There are many, many takeover situations, many leveraged buyouts, many mergers that are clearly beneficial. There are many managements that are ineffective. There are some managements that ought to be taken over. There are some boards of directors that are not exercising their responsibilities properly; they ought to be thrown out. And the free market system ought to be allowed to work.

So one has to be very careful in this area, which [illegible] not to say that at the margin there are not situations engendered by technological innovation—and my own company understands very well because that is our business—and various other reasons, that give me concern. And I have been very careful to focus on those situations but not at all to underestimate the importance of the free market system allowing mergers, acquisitions, buyouts, even leveraged buyouts. That is why I made the point that they are not in and of themselves bad at all.

Mr. CHANDLER. Have companies utilized exchanging debt for equity as a defense against a merger or a takeover? Has that commonly happened? Usually we hear leveraged buyout for the other direction, but has it been used as a defense, in your opinion?

Mr. BLUMENTHAL. Sure, restructuring is a euphemism most of the time, the way I have come across it. It has been a euphemism for paying out, which means in most instances paying out a lot of borrowed money, paying it out to the shareholder, leveraging yourself, and in this way buying a lot of your own stock by paying out a premium over the market, and thereby fending off an attack. It becomes a competitive situation. The attacker offers 50, and you figure out whether by doing this kind of transaction you can give your shareholders 55. When he offers 57, you see whether you can pay out 60.

And that type of situation, where in the end you use the most expensive, risky, worst kind of junk, is the kind of situation I am concerned about, because that is the kind of company that will go under when the economy turns down; or it is most likely to go under when the economy turns down.

Mr. CHANDLER. So, what you end up with is a junk being used to defend against junk, in a sense. Almost either way it goes, the company is going to be weakened by that activity.

Mr. BLUMENTHAL. Competitive junking is what we are talking about.

Mr. CHANDLER. Yes.

But now, if that is the case, clearly with the smaller, newer companies, debt has got to be very likely a very high ratio to their equity. And so we do not want to discourage that kind of debt because great damage could be done. But in the instance we have just discussed, that ought to be discouraged. How the devil do we do that?

Mr. BLUMENTHAL. I think there is one possible approach, and I am neither an expert in it nor technically qualified to tell you exactly how to do it. But I think you have put your finger on it. For what purpose is the debt being incurred? If the debt is being incurred to buy back your own stock at a premium, then that is a little different than if the debt of a young, new company is being incurred for the productive purpose of investing in R&D and plant and equipment and in the kinds of activities which make this economy and that company more efficient in the marketplace.

Mr. CHANDLER. You mentioned in your testimony that the Treasury now has the authority to write regulations in this area. Do you think they have the authority to make that distinction in deductibility of interest?

Mr. BLUMENTHAL. I am not sure they can do that, but they can do a lot in that area.

Mr. CHANDLER. That might be guidance that we can perhaps give them.

Mr. BLUMENTHAL. Yes.

Mr. CHANDLER. Thank you.

Chairman ROSTENKOWSKI. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

I have one brief question. Has the legislation that I proposed a couple of years ago and which was subsequently enacted by Congress calling for an excise tax on greenmail, had an impact on greenmail? I have not heard of any greenmail payments being made since the legislation was enacted. As you recall, we enacted a 50-percent excise tax on greenmail above the normal income tax to give those folks the ability to contribute to their government, hoping, of course, that we shut down greenmail. Some have said there are some ways around it, but frankly I have not heard of anybody receiving greenmail since the law was passed.

Mr. Ball, are you aware of any?

Mr. BLUMENTHAL. I hasten to add that I am not an expert on greenmail, either in the giving or the receiving. I suspect that the definitional problem that you would face would again be severe. What is greenmail, and what is a legitimate profit that someone makes who has invested in the company? It is probably not that easy.

Mr. DORGAN. Well, we have defined it. And my question was, does the law by which we defined it, imposing a 50-percent excise tax, effectively shut this down? Are there greenmail payments being made, because I am not aware of any?

Mr. BALL. It has worked very well.

Mr. GUARINI. If the gentleman will yield, I understand Texaco just had a situation where Mr. Icahn was supposedly, according to newspapers, to benefit by some $70 million at a 10-percent tax rate. So, I am sure that they are finding ways and devices to get around what you might otherwise call greenmail.

Mr. DORGAN. Mr. Ball, you indicate that the law probably has——

Mr. **Ball.** I think the law has worked very well. I think the Texaco case is an example of artful crafting by lawyers who are quite good at devising ways around most things. The specific law has been quite on target.

Mr. **Dorgan.** I asked the question because I think we may need to make some modifications here to make it even stronger. But I think we have had an impact by the actions of this committee.

I appreciate your response.

Chairman **Rostenkowski.** Mr. Gibbons.

Mr. **Gibbons.** I am glad to see you back. You look younger than you did when you were here the last time.

Mr. **Blumenthal.** So do all of you.

Mr. **Gibbons.** Well, we take that as a compliment, and I mean it in your case.

I don't get too worried about this hearing that we are having and the subject matter that we are talking about. I started practicing law right after World War II. I got out of law school and had learned all those fancy rules about usury and interest rates and everything else that they taught you in business school and in law school. When I got out there, I found out that the people on the outside knew a lot more about it than I did. And if I had some reason why it would not work, they had a dozen reasons why they could work it, and they did; and most of them did real well. And they did it honestly and they became wealthy. Some of them even allowed me to participate in some of their wealth. So, I am not mad at them, I am happy about them.

I really see the problem we have here, as we put taxes on dividends and no tax on interest, whenever it is a question in somebody's mind as to whether they go the interest route or the dividend route, they are going to go the natural route. And that is the one where they save the most money, and that's interest.

Is that what they do?

Mr. **Blumenthal.** Well, you are quite right. I did mention that prominently as the area on which I hope the committee and the Congress will focus. I understand that there is a very important revenue implication of making this change. But anything that can be done, step by step, moving in the direction of eliminating that difference in treatment would be very helpful. I certainly would strongly support it.

Mr. **Gibbons.** That is a basic fundamental problem that we have here.

Now, let me kind of pick on your depth of knowledge when you were Secretary. If we get forced back into doing something about capital gains, would you advise us to define capital gains as we used to define them? Or would you suggest a much narrower definition?

Mr. **Blumenthal.** I am not going to evade your question, but I am going to try and answer a little differently. I feel strongly that in the kind of world we have moved into since I used to come before this committee, where things are really becoming totally interrelated between ourselves and other countries with just enormous speed and continuously so, that the big problem that we face is to find ways to increase the capital stock and the efficient use of that capital stock to create jobs and to make ourselves competitive in the world, keep ourselves competitive in the world. That is the fundamental problem, how to increase our capital and use it efficiently.

We are not doing well in that area. I think that is the fundamental issue that this committee and this government will face over the next several years. What can we do in order to encourage capital accumulation and the efficient use of that capital? We are too consumer-oriented as a society. You know that very well.

I think it is important that the committee and the Congress reconsider with the administration a way to encourage a willingness to hold assets for the longer term rather than for the quick buck, just for that reason.

So my answer to you would be, if you do tackle capital gains again, then the definition that you choose ought to be with that principal goal in mind. Now, whether that means it is the same as it was before, or somewhat different, I will leave to the technical crafters. But that is the fundamental goal that any change in capital gains——

Mr. GIBBONS. Well then you would not apply capital gains to real estate, for instance, wholly raw land?

Mr. BLUMENTHAL. I think that distinctions could be made between that and certain other types of capital.

Mr. GIBBONS. Well, I see the red light is on. I will pass.

Chairman ROSTENKOWSKI. Thank you very much for joining us. I hope you catch your airplane. Thank you.

Mr. BLUMENTHAL. Thank you.

Chairman ROSTENKOWSKI. Mr. Ball, we are ready to hear your testimony and then interrogate.

STATEMENT OF GEORGE L. BALL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, PRUDENTIAL-BACHE SECURITIES, INC.

Mr. BALL. Thank you, Mr. Chairman.

I will be brief and will just try to focus on a few specific ways in which we might be able to keep the beneficial baby that comes with many buyouts while throwing out the bath water of excess or greed that has accompanied some of them.

On balance, let me note, as outlined in my full text, that LBO's have been a clear plus to the Nation. They are a positive. Despite that, however, all is not well. Unfortunately, some few but new measures may well be needed.

First, as I've traveled around the country recently I have run into a maelstrom of complaint from individuals and institutions about what they perceive at least to be sometimes brazen shortchanging of shareholder interest by management-led buyout groups of publicly traded companies. That problem is a very real one, in my view at least. For example, in several cases management as a would-be buyer has initially offered the public a lower price than that which it ultimately paid after competing bids were made by others. That implies that in the absence of rival offers, the management group would have paid less to the stockholders than it thought the company was really worth. That is not right, it would seem.

Now, to resolve that conundrum probably one of two alternatives is possible. First, you could say that management groups bidding for public companies are permitted one bid only, that they could not low-ball and then move upward. But that may be too severe, too draconian.

A second would be to require the formation of a committee to advise the shareholders and the shareholders only, separate from the management and separate from the board of directors. That committee would be paid for by the bidding management group but would have explicit links only to the shareholders with full and unfettered access to the records, the books, and the personnel of the company. That way the shareholders could be insured of a fair price.

The second question you are facing has to do obviously with the conversion of corporate capital structures to debt from equity. And even though this imbalance has existed in a tax codified way for many years, it is only in the last few that there has been the development of the exotic instruments that Secretary Blumenthal was talking about to take advantage of them.

Over the years, this committee together with business people like myself, has grappled with ways to solve that riddle rather unsuccessfully. We should strive again, and I would submit to you a recent heretofore unpublished study by the Securities Industry Association's economists that suggests a seemingly palatable combination of deductibility of dividends with a slightly reduced tax break for interest expense.

Specifically, if you had only 86 percent of interest deductible, you could have 50 percent dividend deductibility and achieve revenue neutrality, according to the preliminary work done by the SIA. I think that that is not a bad trade. And although other combinations are possible, that is something that smells good to me from the standpoint of realistic public policy that could be politically feasible. And I just have a sense that it would be good for the country's businesses.

Finally, another measure is needed if we are really to improve the way that the securities markets serve the Nation. Regrettably, there has been a collective lust for immediate financial gratification by individuals, by institutions, by companies, by arbitrageurs, and that has fostered an unhealthy promiscuous attitude toward investing. Behavior has been bred that is inimical to the proper functioning of our Nation's economic engine.

Now, it may not be possible to cure that lust entirely, but at least we can channel it. We need a policy that redirects investment toward the long-term economic interests of our country.

One part of it has been suggested, and that is a capital gains tax rate of, let us say, 15 percent. The problem you face is that some parties would say that is going to cost $5 billion. Others would say it is going to raise $5 billion. And you need to balance something between the two.

It was suggested last fall that a surtax on short-term gains of, let us say, 5 percent levied on institutions, whether taxable or tax exempt currently, on individuals and on foreigners, would do a great deal to rechannel their drive toward more proper, long-term uses of the investment markets. You could cut the capital gains tax rate, let us say, to 15 percent, since that has been talked about, but ought to couple with it a tax on short-term flipping, as it is called in the trade. If you did that and applied it to all parties—tax-exempt institutions, corporations, and individuals—I think it would do a real public service and cause the Tax Code to lead investment back into the proper, most productive uses of our capital resources.

Thank you. I would be pleased to answer any questions.

Chairman **Rostenkowski**. Thank you, Mr. Ball. Without objection, your statement will be inserted into the record.

[The statement of Mr. Ball follows:]

TESTIMONY OF

GEORGE L. BALL
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
PRUDENTIAL-BACHE SECURITIES INC.

BEFORE THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
FEBRUARY 1, 1989

Thank you, Mr. Chairman.

The following comments focus on how to improve the workings of the securities markets in light of the issues being addressed by the Committee. We've tried to find ways to keep the beneficial baby that comes with many buyouts while throwing out the bathwater of excess or greed that accompanies some restructurings.

From a financial perspective, the leveraged buyout is a free-market response to the inefficient stock exchange valuation of many of the multi-industry companies formed in the 60s and 70s. In the late 70s, institutional investors and managements began to realize that many diversified concerns were worth more in pieces than what they sold for whole (that's w-h-o-l-e). The leveraged buyout is, in fact, largely a mechanism spawned by the marketplace to realize these values. As such, it should be welcome.

Of course, like anything else except good company or good health, LBOs, taken to an extreme, can have negative overtones. To begin with, there is the danger of an excessive shift from equity to debt on the balance sheets of corporate America. You've heard a lot about that.

There is the vulnerability of highly leveraged U.S. companies to severe recessions, unexpected interest rate increases and disappointing earnings forecasts. It's a real risk.

Third is the potential for nest-feathering by managements and their advisers who might pluck the down from the hide of the very shareholders they've been hired to serve.

Finally, there is the threat of widespread fixation with short-term economic gain, of which some leveraged corporate takeovers are emblematic. Greed isn't good, no matter how you paint it.

But, as an economic catalyst, the LBO has basically been positive in its use and effect. There is a risk, therefore, that we peer under the bed so hard that we see problems that aren't there. That we sometimes hyperbolize those that we do see. And that we might seek to shoot real bullets at figments of our fears.

Indeed, in today's global economy, we jeopardize the competitiveness of this country's precious capital markets when we try to tinker with them unnecessarily. And those markets are a national treasure. Ideally, their self-correcting propensities should be allowed to function relatively freely. Indeed, where corporate restructuring is concerned, it's arguable that the Invisible Hand is already working quite well.

Even with that said, all is not well, however. Look, for instance, at the surge in corporate indebtedness associated with buyouts. Recent analysis reveals that the corporate debt to equity ratio has risen to its highest level since 1970. This surge reflects not only an increase in the absolute amount of corporate debt, but also a dramatic reduction in outstanding corporate equity during the last several years. In 1988 alone, acquisitions, share repurchase programs and LBOs whacked a full $250 billion from equity capital--and a kindred sum was retired during the previous four years. That's $500 billion in half a decade. Prudential-Bache's chief investment strategist, Greg Smith, forecasts that a net of another $150 billion will be withdrawn from the stockmarket in 1989.

This evisceration of equity is a function of both supply and demand. It stems, in part, from the persistence of high, deficit-driven real interest rates, which have heightened the relative appeal of fixed-income investments. It also reflects a widespread belief, one exacerbated by the 1987 Crash, that the stock market is unfair, too volatile and, accordingly, an inefficient vehicle for valuing corporate shares. Consequently, to finance their activities, corporations have been prompted to tap the credit markets more extensively than in the past.

Thus, the stage was set for headlines last year sensationalizing a few transactions that established new size ceilings. But those ballyhooed deals were not at all representative of the restructuring norm. They were anomalies.

Most leveraged transactions fall in the middle range or even further down the scale. They are not the mega-deals which capture the minds of the media. For example, the 134 LBOs closed by the Prudential Investment Corporation since 1980 averaged just over $50 million in size, with 70 % of them under $50 million. In fact, only 17 exceeded $100 million.

Indeed, in sharp contrast to some of the more notorious transactions, most deals take place in the private market, on a relatively small scale, with the direct and continuing involvement of management, and for sound economic reasons. Typically, although admittedly not always, they're not predicated on asset sales, employee layoffs or plant closures, but on present and future cash flows.

By the way, while exceptions may exist, the credit analysis done in most of these transactions by the lenders and underwriters has been pretty darn good. Thus, it would be wrong to infer that the sizable stockpiles of funds seeking acquisition or buyouts have sought deals so desperately as to make them overpriced. Not at all. Instead, for the most part, buyout funds were correctly conservative, even at the risk of being slow to commit their investors' funds. And it appears that major institutions, sensing a drought of worthy opportunities, are now less inclined to give them any new money. They are moving like a Redskins' tackle at the end of a 100 yard chase.

All of this suggests that the market, as broadly defined, has been a non-feculent arbiter of the worthiness of potential restructurings for companies, shareholders, workers and therefore the economy. Still, to ensure fairness, one needs to insist that disclosure rules ensure adequate and relevant information. Unshuttered and unfiltered sunlight is the best guard against the managerial wrongfulness and the conflicts of interest that can sully an otherwise cathartic restructuring process.

In that regard, some few, but new, measures may be desirable. First, in recent visits with investors around the country, both individuals and institutions have complained to me about what they perceive to be sometimes brazen short-changing of shareholder interests by management-led buyout groups of publicly traded companies. The problem is a real one, in my view.

For example, in several cases, management, as a would-be buyer, has initially offered public shareholders a lower price than that which it ultimately paid after competing bids were made by others. That implies that, in the absence of a rival offer, the management group would have paid less to the stockholders than it thought the company was worth. That's not right. To resolve that conundrum, one of two courses is possible. First, it's been suggested that management groups bidding for public companies be required to put forth their highest price first. They would be prohibited from low-balling and then moving upward, if opposed. But that's perhaps too restrictive, too draconian.

Alternatively, one might require the formation of a shareholder committee, separate from management or the Board of Directors, which would independently assess the fairness of any such management bid. The committee would be paid for by the bidders personally, and would not have explicit or implicit links to anyone other than the owners of the shares. It would have full and unfettered access to the books and records of the company and, thus, should be able to ensure a fair price for the stockholders.

Another set of issues has to do with the cause of the shift from equity to debt. The deductibility of interest lowers the after-tax cost of debt relative to equity, for dividends remain doubly taxed. Even though this imbalance has existed for a long time, only in the last few years has it been widely exploited at the corporate level through buyouts financed with ever more exotic debt instruments. It's troublesome viscerally and fiscally.

Over the years, we have grappled with various corporate integration and dividend relief proposals without enacting any of them. This is largely for valid fear of excessive revenue loss. A divided business community has also not helped matters, although we came close to agreement during consideration of the 1986 tax bill.

Nonetheless, we should begin 1989 by striving once more. One starting point could be recent staff work by the Securities Industry Association that suggests that a seemingly palatable combination of partial dividend deductibility with a slightly reduced break for interest expense would not violate the federal goal of revenue neutrality. This preliminary analysis indicates, for example, that a 50% dividend deduction could be offset by making 14 % of interest expense non-deductible. That's not a bad trade.

You've also heard a great deal about strengthening so-called thin capitalization rules which require a minimum amount of equity in a transaction before interest can be fully deductible. My guess is that you should skip that track. Almost any interpretation devised would be circumvented by smart investment bankers or lawyers faster than you can say Stealth bomber.

With a policy of that nature, corporations would be encouraged to turn to the equity markets in greater numbers. Therefore, their exposure to potential debt-induced calamity would decline. It would spark investor demand for stock, deepening the liquidity of the marketplace, reducing volatility and fueling the constructive kind of risk-taking by companies that for decades made America a peerless economic engine.

But another measure is needed if we're to lengthen investors' time horizons. Regrettably, the collective lust for immediate financial gratification--by individuals, institutions, arbitragers and companies alike--has fostered an unhealthily promiscuous approach to investing. Behavior has been bred that is not sound fuel for our nation's economic engine.

Fully curbing that lust may be impossible, but it can be bridled. The right place to start is with the tax treatment of capital gains. Policy should reward those willing to take a long-term stake in America. It's my firm belief that a long-term rate of 15 % would greatly help to effect such an outcome.

At the same time, however, tax law could also penalize short-term gains with a surcharge perhaps in the area of 5 %. And that surcharge should apply to all--to so-called tax-free institutions as well as others, domestic and foreign alike.

Although this suggestion spawned knee-jerk negatives in some impacted circles when it was initially offered last fall, many found value in such an approach. While gains resulting from LBOs are primarily long-term, there are those who are just in there for the moment, for the quick buck. They flip securities, in the parlance. That is not capital formation. By raising short-term rates, more distant horizons would prevail. By applying it to entities which do not otherwise pay taxes, one would rechannel them toward the sort of investment behavior desired and expected in the first place. And reducing long-term capital gains rates would unlock capital which would move to higher valued uses.

With that, thank you again for the chance to present my thoughts to you today, and I would be pleased to answer any questions.

Chairman ROSTENKOWSKI. We have heard testimony that current LBO activity may slow down on its own without any legislation. What is your opinion in this regard, Mr. Ball?

Mr. BALL. I would be somewhat skeptical of that, Mr. Chairman. Last year there were $250 billion of equities retired from our Nation's markets, according to Greg Smith, who is our firm's highly regarded chief investment strategist. That compares with $313 billion in the preceding 4 or 5 years, as I believe you have heard.

There are currently pools of money out there looking to invest $260 billion in 1989 in LBO-like activities. Now, they may not be successful, but I would not want to bet against them. So I think the idea of a cresting is perhaps hopeful rather than realistic.

Chairman ROSTENKOWSKI. Are the fees in the deals the driving force, Mr. Ball?

Mr. BALL. I do not believe the fees in the deals are the driving force. I believe that there is on the part of managements and people in the money business like myself and our firm a desire to control companies. They see now that, with cash flow streams that will retire debt just as mortgages are paid off by monthly payments, they can control and capture entire companies putting up just a little bit. So I do not think it really is a fee-driven phenomenon, but it is an understanding of the degree to which high degrees of leverage can work to the apparent gain of a group of management or other parties.

Chairman ROSTENKOWSKI. Mr. Guarini.

Mr. GUARINI. Thank you, Mr. Chairman.

It is good to see you again, George.

Do you subscribe at all to a floating, flexible cap on loans in a corporation? Should there be a limit as to how much the equity bond or stockholder could be watered down?

Mr. BALL. Having looked at this during 5 years as the head of the securities industry's tax policy and capital formation committee, and having a very high degree of regard for the lawyers and investment bankers in the industry, I despair to some extent as to the ability of the Tax Code to scribe anything that cannot be circumvented rather quickly.

So, I like the idea but, as we have played with ways to actually do it, we have not been able to craft anything that would stand up against the onslaught of the brilliant law firms and investment banking firms around.

Mr. GUARINI. Anything we write can often be gotten around. And then if we put some things into place, we do not know what the ultimate result is going to be because it can trigger many things that the committee does not even foresee.

Mr. BALL. Oftentimes, lawyers and bankers can circumvent you faster than you can say Stealth bomber, and that is rather quick.

Mr. GUARINI. Tell me in regard to foreigners, our people have a tax to pay on income. We repealed the 30-percent withholding tax that foreigners had to pay. Is there an unlevel playing ground here? Are we now in a world that is so interdependent, allowing foreign investors to be on an unfair playing ground with our own people, where they have a distinct advantage of not having to pay capital gains taxes or not having to have withholding on income?

Mr. **Ball**. The inequality between foreign investors and U.S. investors in the tax jungles is something that has not yet worked against us as it will in the future, but it could be a mighty bastion of despair for our country at some future point.

As a role model, this committee introduced and passed legislation some few years ago which would tax the gain on the purchase and subsequent resale by a foreigner of farmlands. I understand the implementation of that has been uneven in success but still probably on balance successful. Something like that at a point in time is going to be quite vital to the national interest as it applies to corporate shares—not just to farmland.

Mr. **Guarini**. The irony of it is a few years ago there was no capital gains taxes on anybody who bought real estate and lived in the United States for less than 6 months. But there was withholding tax on any income that they would realize from rent or profits of 30 percent. Then we reversed it and turned it around completely. Now there is a capital gains tax but there is no withholding tax. It seems that we are not very consistent.

I am asking you, if you were king in the best of all worlds, how would you structure taxes for foreigners in this regard?

Mr. **Ball**. If I were Zeus on Mount Olympus, I would probably prefer the capital gains tax route collected at the source as being simple. The tax legislation that seems to work the best is very, very simple. And given the complexities of the tax treaties between and amongst the various countries, again I think there are avenues that might be open for people to evade the intent of the laws.

Mr. **Guarini**. Do you think there should be withholding taxes reconstituted?

Mr. **Ball**. I think withholding taxes at the source would be a very good idea.

Mr. **Guarini**. I agree with you.

Thank you very much.

Chairman **Rostenkowski**. Mr. Dorgan asked a question about the 1987 act on greenmail. Would you like to enlarge on that? He did ask the question of you.

Mr. **Ball**. The impact of the 1987 anti-greenmail law has been very favorable. There may have been isolated cases where egregious amounts were paid to escapist corporate managements, but if so, they are very, very few, and far between, and they have escaped my admittedly failing but still at times adequate memory. I think it has been a piece of legislation that came on the footsteps of a public furor and has caused greenmail to be a battle of the past rather than one of the future, and that is very good.

Chairman **Rostenkowski**. Mr. Ball, thank you very much for your participation. We really appreciate it.

Mr. **Ball**. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Kanaga.

Welcome to the committee, Mr. Kanaga. If you are ready to proceed with your testimony, if you would like to summarize it, feel free to do that. Your entire statement will be put in the record. You may proceed.

STATEMENT OF WILLIAM S. KANAGA, CHAIRMAN, U.S. CHAMBER OF COMMERCE, AND CHAIRMAN, ARTHUR YOUNG & CO.

Mr. KANAGA. Thank you. I will summarize.

My name is William Kanaga. I am chairman of the U.S. Chamber of Commerce and come here today representing the views of the chamber. The policy issues that are being raised by the recent increases in mergers and acquisitions and LBO's are complex, as we have just heard from the two witnesses preceding me.

Certain aspects of the present situation are very concerning to us, and the chamber commends this committee for its efforts to carefully examine them. However, as you consider any policy changes we also recommend that you do not reach the law of unintended consequences, because many times they do have unintended effects upon the U.S. economy.

As a matter of fact, even proposing changes sometimes, as we found in 1987, has a dramatic impact on the marketplace. Many perceive this as a problem of unprecedented levels of corporate debt, risking future stability and health of the economy. Others are concerned about untangling the rights of shareholders and bondholders and management and employees. There is a definite need to better define the problem that any proposed policy would address. We have to keep it all in perspective. Corporate debt levels have been increasing gradually in recent years. As a percentage of GNP they have gone up to about 37 percent compared to 30 or 35 percent during the last two decades. However, the ratio of debt to equity measured by book value is very close to the level of the early 1970's, and as a matter of fact dramatically lower than the ratio of debt to market value during the decades of the 1970's.

Critics argue that these mergers divert billions of dollars that could be spent on productive research and development, new production facilities. A firm testified last week before the Senate Finance Committee that in fact the spending after the acquisitions with which they were involved, and they are the largest firm in the business, were some 15 to 20 percent higher both on research and development and on capital equipment in the 3 years following the acquisition.

Yale Brozen, who is a professor from your area of the country, an expert in this arena, has shown in his research how mergers can lead to higher efficiency and productivity. I could go through those. But that has been demonstrated.

In the Chicago Fed letter in January, a researcher estimated that the gain to shareholders of publicly traded companies from 1981 to 1986 was some 48 percent, or $134 billion, which is a significant gain that has been passed to shareholders and reinvested, I would think, typically.

LBO's in themselves typically put the ownership back in the hands of managers and turn them into entrepreneurs. The real problem as we see it is that the present tax system is biased against equity finance. I would echo the comments of Mr. Blumenthal that that bias against dividends and the double taxation and even triple taxation of dividends could well be abated. I believe this committee and the House did take some steps along that line about 3 years ago.

The second area, capital gains are taxed at too high a rate, at both the corporate and shareholder level. When we looked at the period around 1980–81, we are looking at a period where the ordinary income tax rates were much higher, therefore the bias was towards equity investment and capital gains treatment rather than the stream of interest income. The provisions we now have in place tend to raise the cost of capital, reduce long-term economic growth and impede the ability of U.S. businesses to compete in the international marketplace. Taxation of capital gains and dividend income in Germany, Japan, the United Kingdom, is all at an entirely different basis and far more favorable than the United States.

The United States is one of the few countries that fully taxes corporate income and corporate dividends paid to shareholders. Corporations are taxed at a rate of 34 percent. Shareholders are taxed again on those earnings. Thus the effective rate on distributed income comes often as high as 56. That is Federal, and you add State taxes on top of that.

I live in the State of Massachusetts, and there is a significant additional State tax, and the Governor there is proposing even more.

To reduce the tax bias against equity investments, and to reduce the cost of capital to American firms, Congress should implement a program of dividend relief. That has been proposed to you before. I won't spend time going through the details.

The 1986 act repealed the capital gains differential. Top capital gains rate for individuals was raised from 20 to 33 percent, and corporations 28 to 34. These capital gains rates substantially reduced the attractiveness of equity investment.

To reduce this bias against equity investment, the chamber advocates a reduction in the capital gains tax rate. This can be achieved in several ways, the traditional means being an exclusion of a portion of the gain, imposition of a lower alternative tax or indexing capital basis for inflation, the way the United Kingdom does.

Reinstating the capital gains differential also ranks as the only remaining pro-growth revenue-raising initiative available to Congress, and I indicate that in my submission to you. There was a definite boom in revenues when the capital gain rates are changed, and lowered.

Interest is a business expense and should be deductible as such. The chamber is opposed to limiting the deductibility of interest. The central reason interest should remain deductible is fairness. A tax system that purports to measure and tax net income or profits should allow expenses incurred to offset income. Limiting the deductibility of interest expense incurred by U.S. corporations will simply raise their cost of capital, which is already higher than their foreign competitors, and those people will remain able to deduct their financing costs.

Similarly, if interest expense incurred by a U.S. firm making an acquisition were not deductible, then foreign firms would be placed at a competitive advantage, a competitive advantage to our own.

Thank you very much for hearing me out.

Chairman Rostenkowski. Thank you, Mr. Kanaga.

[The statement of Mr. Kanaga follows:]

STATEMENT
on
CORPORATE DEBT, MERGERS, ACQUISITIONS AND LEVERAGED BUYOUTS
before the
HOUSE COMMITTEE ON WAYS AND MEANS
for the
U. S. CHAMBER OF COMMERCE
by
William S. Kanaga
February 1, 1989

My name is William Kanaga. I am Chairman of the U. S. Chamber of Commerce and of Arthur Young and Company. I am here today representing the views of the Chamber. Because of its broad membership base, the Chamber offers a unique perspective on the problems that we are addressing here today.

The policy issues raised by recent increases in merger and acquisition activity, leveraged buyouts (LBOs) and corporate debt levels are complex. Many aspects of the present situation are troubling, and the Chamber commends this committee for its efforts to deliberately and carefully examine what legislative changes are appropriate. Any policy changes will have profound, far-reaching and often unintended effects on the U.S. economy. Often simply proposing a policy change will have a dramatic impact on the marketplace. Thus, prudence should be the watchword as Congress proceeds to examine its options in this area. Throughout the entire process, the ultimate goal of any legislation should be to promote long-term economic growth, competitiveness and prosperity.

Defining the Nature and the Dimension of the Problem

There is clearly more press coverage of corporate mergers and acquisitions, LBOs and the level of corporate debt than there has been in the past, and an entirely new lexicon has been developed to describe the world of takeovers, mergers and acquisitions. Poison pills, pacman defenses and junk bonds are now part of the everyday language of finance. There is a widespread feeling that this activity deserves careful scrutiny to ensure that the economic health of the U.S. is not endangered and that employees, bondholders, stockholders and management are treated equitably.

Many perceive the "problem" to be unprecedented levels of corporate debt, which risk the future stability and health of the economy. Others are concerned about equitably untangling the rights of shareholders, bondholders, management and employees as huge deals are consummated and radical restructuring takes place. There is a definite need to better define the "problem" that any proposed policy would address.

But we must keep all of this in perspective. Corporate debt levels have, indeed, been increasing very gradually in recent years. As a percentage of Gross National Product, corporate debt stands at about 37 percent compared to 30 to 35 percent during the period 1967-1985. The ratio of debt to equity measured by book value is very close to the level of the early 1970s. Measuring equity by market value, the present debt-equity ratio is almost the same as in 1984 and dramatically below the levels reached during most of the 1970s.[1] The ratio of net interest to cash flow has ranged from 18 to 22 percent during the 1980s and is not presently even at its peak.[2] Seemingly, the only thing that has changed dramatically is the dollar value (but not the number) of all mergers and acquisitions, which has increased from $12 billion in 1975 to $164 billion in 1987, and the number and dollar value of LBOs.[3]

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[1] Joint Committee on Taxation, "Federal Income Tax Aspects of Corporate Financial Structures," January 18, 1989, p. 65.

[2] Ibid, p. 67 with errata.

[3] Ibid, p. 11.

In Europe and Japan, debt loads have been higher than in the U. S. without causing a catastrophe. It is true that the relationship between lenders and corporate borrowers in other countries is quite different from that in the U.S. Japanese bank lenders often also own a stake in the borrowing companies and therefore can defer interest payment or refinance debt when companies get into trouble. A similar relationship between lenders and borrowers can develop in the U.S. For example, many buyout firms that provide financing for LBOs also own large stakes in the companies that are bought out.

Critics of mergers and acquisitions argue that these mergers divert billions of dollars that could be spent on research and development or new production facilities. Moreover, they argue that mergers increase concentration, promote monopolistic power, and reduce competition. Yale Brozen, an expert in mergers and acquisitions from the University of Chicago, has shown in his research how mergers can lead to higher efficiency and productivity.[4] By increasing their size through their acquisitions, companies can economize in staff functions and raise capital at less cost than smaller or less diversified firms. They may be quicker to take action when performance in a particular division lags or move more rapidly to discontinue inefficient or unproductive operations. By moving employers and capital from less productive to more productive applications, they contribute to economic growth and improvements in the standard of living.

Sometimes, however, LBOs result in spin-offs and breakups that reduce the size of the affected company to a less bureaucratic, more agile size.

LBOs have been attacked for diverting capital through meaningless paper-shuffling and for diverting managers' attention away from their businesses. Typically, LBOs put ownership back in the hands of managers and turn them into entrepreneurs. This further motivates them to improve earnings. LBOs also provide the market a way to force major restructuring of business, making it more competitive. Thus, LBOs improve resource allocation and efficiency and encourage value-maximizing behavior and may have contributed to the boost in productivity and competitiveness of the 1980s.

Other critics of LBOs and takeovers charge that because new management must look for ways to pay down quickly the new debt, some employees are laid off and research and development is reduced. A study by the Securities and Exchange Commission concluded that companies with low levels of research and development are actually more likely to become takeover or LBO targets than those with higher levels.[5] There is evidence that takeovers may actually lead to more jobs. A survey by Kohlberg, Kravis, Roberts of 15 client companies found that those LBO firms now employ 313,000 persons, up from 276,000 when the LBOs took place.[6]

The most common concern about current borrowing practices expressed by some members of Congress and the Administration is that the heavy debt might lead to a contagion of bankruptcies and bank failures in the event of a recession resulting in widespread economic instability. It is, however, not likely that the default will be so widespread that the federal government will be forced to bail out borrowers or lenders. Mutual funds, pension funds and insurance companies have diversified portfolios. The banks are well-secured in most deals. Even if the LBO winds up in bankruptcy, the banks are secured in two ways: they have a claim on the company's assets, and as senior debtors, they get paid first from any available cash. Furthermore, most heavily indebted companies that have gone through mergers and restructuring can probably carry their debt in a recession. Most of these companies are in industries -- such as food or publishing -- that suffer least in a slump.[7]

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[4] Brozen, Yale, *Concentration, Mergers, And Public Policy, 1982.*

[5] Gregg A. Garrell, Ken Lehn and Wayne Marr. "Institutional Ownership, Tender Offers, and Long-Term Investment," April 19, 1985.

[6] Unreleased study; confirmed by telephone.

[7] See, e.g., Statement of Federal Reserve Board Chairman Alan Greenspan before the Senate Finance Committee, January 26, 1989.

Critics also express concern about fairness to shareholders. Some critics charge that LBOs enable management to acquire a company from shareholders for too little when it takes the company private. However, research clearly indicates that stockholders gain when firms are acquired in mergers and acquisitions. They benefit by receiving returns above those that would have occurred had the stock followed overall market movements. One researcher conservatively estimates the gain to target shareholders from takeovers of publicly traded companies between 1981 and 1986 to be 47.8%, or an estimated $ 134.4 billion.[8]

The Tax Bias Against Equity Finance

Our present tax system is biased against equity finance. There are two primary reasons for this bias. First, dividends are double and sometimes triple taxed under present law. Second, capital gains are taxed at too high a rate at both the corporate and shareholder level. These provisions tend to raise the cost of capital, reduce long-term economic growth and impede the ability of U.S. businesses to compete in the international marketplace.

The U.S. is one of the few industrialized countries that fully taxes corporate income and corporate dividends paid to shareholders (see Appendix). U.S. corporations are taxed at a rate of 34 percent. Shareholders are taxed again on those earnings when they are distributed at rates as high as 33 percent[9]. Thus, the effective federal tax rate on distributed earnings is often as high as 56 percent. When state taxes are considered, the effective rate on distributed earnings often exceeds two-thirds.

The Dividends Received Deduction

Intercorporate dividends are often triple taxed. The payor corporation is taxed on its income, the recipient corporation is taxed on its dividend income and the recipient corporation's shareholders are taxed on their dividends as well. Almost since the advent of the income tax, our tax system has provided a dividends received deduction (DRD) to alleviate this triple taxation. Presently the DRD stands at 70 percent for most intercorporate dividends. Thus, intercorporate dividends are 30 percent triple taxed.

Last year's House tax bill contained a provision that would have reduced the DRD to 50 percent. This was widely viewed as a prelude to outright repeal of the DRD. This proposal would exacerbate the tax system's bias against equity finance. The DRD plays a particularly important role in the preferred stock market. A very high percentage of this important means of equity finance is held by other corporations. A reduction or repeal of the DRD would have a devastating impact on the ability of firms to use preferred stock as a method of corporate finance. DRD repeal would raise the tax cost of preferred stock to prohibitive levels and would force corporations to use debt finance. We would strongly urge the committee to retain the DRD.

Dividend Relief Is Appropriate

To reduce the tax bias against equity investments and to reduce the cost of capital to American firms, Congress should implement a program of dividend relief. This could be accomplished in several ways, including a dividends paid deduction, a dividends received deduction or exclusion, a reduced corporate rate on distributed earnings or a system of shareholder credits for corporate taxes paid. Each of these methods has administrative and economic advantages and disadvantages that deserve careful scrutiny. Each of these methods of alleviating the double taxation of equity investment either has been part of the U.S. law at one time, has been the subject of serious legislative proposals or has been adopted by foreign governments. Obviously, in the context of the present federal budget deficit, these reforms would have to be instituted gradually. But with tax revenues growing almost $84 billion annually, there is an opportunity to make very meaningful progress on this front over the next several years if dividend reform is coupled with federal spending restraint.

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[8]"Chicago Fed Letter," The Federal Reserve Bank of Chicago, Number 17, January 1989.

[9] The effective marginal tax rate on most married taxpayers earning a combined taxable income of over $74,850 is 33 percent. Taxpayers filing jointly earning taxable income between $30,950 and $74,850 pay a 28 percent marginal rate.

The Department of Treasury viewed the distortions caused by the double taxation of corporate income as sufficiently serious to make a 50 percent dividends paid deduction a central element of its November 1984 tax reform proposal. Both the President's tax reform proposal and the House tax reform bill contained a 10 percent dividends paid deduction phased-in over a ten year period. A 100 percent dividends paid deduction would make firms largely indifferent between debt and equity finance on tax grounds. Thus, firms would tend to use equity to finance their operations and expansion much more often.

An intercorporate DRD has been a part of the U.S. corporate tax system since 1909 to avoid triple taxation. This system could be generalized by providing a DRD or dividends exclusion to all shareholders, including individuals. Such a reform would eliminate the double taxation of corporate income. A general DRD or dividend exclusion would probably result in a substantially lower revenue loss to the federal government than a dividends paid deduction for two reasons. First, many shareholders would be in lower tax rates than corporations. Thus, the income would be taxed once at the higher corporate rate rather than once at lower individual rates. Second, to the extent that dividends were received by tax-exempt entities, a DRD would involve no revenue loss whereas a dividends paid deduction would.

Our major trading partners generally provide dividend relief. Japan allows shareholders a credit of 10 percent of dividends, which results in an effective marginal tax rate on dividends of one half of one percent.[10] The recent Japanese tax reform reportedly has not changed this provision. Germany provides for total dividend relief. It taxes retained earnings at 56 percent and distributed earnings at 36 percent. Shareholders are given a full 36 percent credit. France and Great Britain eliminate one half of the double taxation of corporate dividends through a credit system. Canada uses a credit system to eliminate more than one half of the double taxation. A summary of various countries' tax treatment of equity investment is set forth in the appendix to this testimony.

Capital Gains Taxation

The 1986 act repealed the capital gains differential, which had been a part of the tax law since the 1920s. The top capital gains tax rate for individuals was raised from 20 to 33 percent and for corporations from 28 to 34 percent. These high capital gains tax rates substantially reduce the attractiveness of risky equity investments and provide an incentive for taxpayers to invest instead in debt instruments. High capital gains tax rates have a pronounced negative impact on venture capital formation, small business's ability to raise capital, the cost of capital and the liquidity of capital markets. The U.S. taxes capital gains more heavily than virtually every industrialized country. Many adopt the sound policy of not taxing capital gains at all. A capital gain is simply the capitalization of an expected increase in a future income stream. Taxing capital gains constitutes double taxation of both the future income stream and its capitalization. Moreover, a high percentage of many capital gains is caused by inflation rather than a real inflation-adjusted increase in an asset's value.

To reduce this bias against investment, venture capital formation and entrepreneurship, the Chamber has taken a leading role in advocating a reduction in the capital gains tax rate. This can be accomplished in several different ways: the traditional means of excluding a portion of the gain, the imposition of a lower alternative tax rate and indexing of capital basis for inflation. Any of these proposals would have a positive impact on equity investment and promote economic growth and job creation.

Reinstating the capital gains differential also ranks as the only remaining pro-growth revenue raising initiative available to Congress. The rate at which investors realize their capital gains is highly sensitive to the capital gains tax rate.

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[10] "Cost of Corporate Capital in the United States and Japan", David Brazell, Aldona Robbins, Gary Robbins and Paul Craig Roberts, Institute For Political Economy, 1985, p. 23.

Capital Gains Rates and the Associated Revenue[11]
(In Billions of $)

Year	Revenue	Tax Rate
1968	$5.9	26.9%
1969	5.3	27.5
1970	3.2	32.2
1971	4.4	34.4
1972	5.7	45.5
1973	5.4	45.5
1974	4.3	45.5
1975	4.5	45.5
1976	6.6	49.125
1977	8.1	49.125
1978	9.1	49.125
1979	11.7	28.0
1980	12.5	28.0
1981	12.7	28.0
1982	12.9	20.0
1983	18.5	20.0
1984	21.5	20.0
1985	24.5	20.0
1986	46.4	20.0

As the table above demonstrates, capital gains tax rates were reduced in 1978 and 1981, and capital gains realizations increased sufficiently for the government to profit.

The rate cut in 1981 was similar in magnitude to that proposed by President Bush. In 1981, the rate was reduced from 28 to 20 percent and revenues grew substantially. President Bush has proposed reducing the top rate from 33 to 15 percent. There is every reason to believe that the positive economic and revenue effects will occur once again.

The Tax Treatment of Interest Expense

Interest is a business expense and should be deductible as such. The Chamber is opposed to limiting the deductibility of interest. A central reason that interest should remain deductible is fairness. A tax system that purports to measure and tax net income or profit should allow expenses incurred to offset gross revenue. To do otherwise would constitute a stark departure from the traditional principles of the U.S. tax system, which has allowed business interest to be deductible from its inception. Moreover, to disallow interest expense would introduce a host of destructive capital market distortions. To the extent that interest expense were not deductible, our tax system would become a gross income tax, similar in many respects to the "cascading" gross sales tax that prevailed in Europe for many years and the gross income taxes that still exist in many developing countries. Gross income taxes are widely denounced by economists of all political persuasions because of the distortions they cause. Under such a regime, two companies that have equal income will often have radically different tax liabilities. Finally, limiting the deductibility of interest expense incurred by U.S. corporations will simply raise their cost of capital compared to their foreign competitors, who will remain able to deduct their financing costs. Similarly, if interest expense incurred by a U.S. firm during an acquisition were not deductible, then foreign firms would be placed at a competitive advantage when bidding on U.S. companies.

The Chamber also opposes proposals that would limit the deductibility of interest expense on a simple debt-equity ratio test. The Treasury has tried to issue regulations limiting interest deductions under Section 385 of the Internal Revenue Code on at least two occasions. In each case, the Treasury withdrew the regulations because they led to unfair and economically counterproductive results in practice. Such a provision would have a pronounced negative impact on all highly leveraged firms. The Chamber is particularly concerned about the impact such a proposal would have on small, family businesses which are usually overwhelmingly debt-financed.

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[11] U.S. Treasury Department, Research Paper No. 8801.

The Role of Pension Funds

Pension funds invest in many different types of investments in an attempt to maximize their return. The investments they have made include high-yield bonds often pejoratively called "junk bonds." The Chamber strongly supports policies that promote a robust private pension plan system. A central element of our tax system that promotes private pensions is the tax-deferred status that they enjoy. Some have proposed taxing pension funds to the extent that they hold so-called "junk bonds." In the interest of maintaining the strength of the private U.S. pension system, the Chamber will oppose proposals to tax pension plan income before it is distributed to retirees under the terms of the plan.

The Chamber is presently reviewing proposals to alter the fiduciary standards governing pension plans under the Employee Retirement Income Security Act of 1974 (ERISA) to insure that their portfolios do not contain too many high-risk vehicles and to insure that plan managers are not under a virtually automatic duty to sell when tender offers are made. Such proposals should not discriminate against any particular type of high-risk investment media, however, but should apply equally to all types of investments.

Securities Law, Financial Regulation and Corporate Governance

The Chamber is systematically reviewing many proposed changes in the securities laws, financial institution regulations and corporate governance law designed to protect bondholders, stockholders and employees. Many of these proposals seem to have merit. But all raise a host of complex questions. The relevant Chamber committees are reviewing the proposals and many will be addressed by the Chamber Board at its February 8th meeting.

Conclusion

Congress should proceed carefully as it addresses the complex issues being raised at this hearing. Any policy proposal should be judged by its likely impact on the cost of capital, competitiveness and economic growth. The policy initiatives that are most appropriate are the provision of substantial dividend relief and the reinstatement of the capital gains differential.

APPENDIX

INTERNATIONAL COMPARISONS OF TREATMENT OF EQUITY G-7 COUNTRIES

Country	Double Taxation of Dividends	Capital Gains Tax Rates For Individuals
Canada	Partial relief from double taxation.	Only a portion of capital gains is included in income.
France	Full relief from double taxation through the combination of a partial shareholder credit and a partial deduction to the corporation for dividends paid.	No capital gains tax, unless the taxpayer has held more than 25% of the shares of a non-listed company at any time during the 5 years prior to sale, or total sales of listed shares for the year are more than FF 288,400 (in 1988). The rate for these exceptions is 16%.
Germany	Full relief from double taxation. Shareholders receive credit for the corporate tax paid.	No capital gains tax if shares are held at least 6 months. If shares are held less than 6 months, capital gains will be taxed at normal rates. A shareholder who owns more than 25% of a company and sells all or part thereof will be taxed at preferred rates.
Japan	Partial relief from double taxation.	No capital gains tax until 3/3/89 (except for substantial trading or substantial shareholders). After 3/3/89 shareholder has a choice of a 20% national and a 6% local tax on net gain at the time of filing, or 1% of sales proceeds withheld at source (this option is available only on shares listed for at least 1 year).
Italy	Full relief from double taxation. Shareholders receive credit for the corporate tax paid.	Capital gains are taxed (at regular income rates) only if the shareholder holds the shares less than 5 years and shares transferred exceed 5% of capital, or 2% in the case of shares quoted at a stock exchange.
U.K.	Partial relief from double taxation.	40% with indexation.
U.S.	No relief from the double taxation of dividends.	Taxed at regular income rate, generally 28% or 33%.

Source: Arthur Young and Company.

Chairman ROSTENKOWSKI. Are there any questions of the witness?

Mr. PICKLE. I will just ask you one question, Mr. Kanaga. If we give the deduction for dividends, how do we offset the revenue loss from the budget, if we don't get into the field of interest deductions?

Mr. KANAGA. I, sir, was not coming here to try to keep a zero basis on, but I believe that I would prefer not dealing, not doing anything with interest deductibility. We had section 385 passed some 20 years ago and we still do not have any regulations that have ever come down that were satisfactory. They have come up with regulations twice, both of them have been shot down, which were intended to limit the deductibility of interest, I believe, on——

Mr. PICKLE. Well, if we don't put some kind of limitation or reduce deductibility of interest in some way, then you are going to be $50 or $60 billion off kilter.

Now is the United States Chamber of Commerce recommending that we go into debt another $60 billion?

Mr. KANAGA. Well, we understand that the revenue, growth in the Federal revenues will be up some $80 billion this year. What we would do is phase it in, and we obviously are not for increasing cost.

Mr. PICKLE. Well, we were going to do that a few years ago with supply economics and that didn't work very well.

Chairman ROSTENKOWSKI. Mr. Kanaga, do you have rose-colored glasses? [Laughter.]

Mr. KANAGA. No, I don't. But, as a matter of fact, I have been in Illinois.

Chairman ROSTENKOWSKI. Well, we don't wear rose-colored glasses in Illinois. And we are not too good at reading lips, either. [Laughter.]

Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman.

Mr. Kanaga, we had testimony earlier today suggesting or recommending that what we might do in the treatment of capital gains is maintain the existing capital gains rate for a time frame of up to 1 year and then eliminate any capital gains tax whatsoever, if you have held an asset for more than 1 year.

I am not sure what the impact of that would be. My own preference would be to eliminate any tax on capital gains whatsoever as the Japanese very intelligently do. On the other hand, I have heard that a 15-percent rate, studies suggest, maximizes revenue while maximizing the generation of venture capital. Does that conform to your study of this problem?

Mr. KANAGA. Yes. We are supportive of the proposal to go to 15 percent. In our submission we show that in 1978 when the capital gains tax rate was reduced, the estimate that was given to you gentlemen was that there was going to be some $2 billion loss in revenue. In fact, there was a $2.8 billion increase in revenue, because it unlocked a lot of capital gains that were setting out there.

In 1986 when you took off the preferential rate the revenue went from $24 billion in 1985 to $46 billion in 1986 in anticipation of 1987 when they would not have a preferential rate.

So we support a reduction, and we have supported that reduction to 15 percent.

Mr. **Crane**. By taxing dividends and capital gains as we do, in contrast to the Japanese, how severely does that handicap our competitive position?

Mr. **Kanaga**. I listened to Mr. Ball testifying. In my opinion, we should move to their tax system, toward their tax system. They, obviously, have used it very successfully—so have the Germans—where dividend tax relief has been given—capital gains tax relief has been given compared to our system, and, obviously, their accumulation of capital, their savings rate is far higher than ours. Our tax system discourages people from investment.

Mr. **Crane**. Well, I was in Japan with the American Productivity Center in 1981, and we talked to a number of businessmen over there, and some of them asked us why we punish people in our country for saving and investing. They noted that they didn't tax dividends or interest at that time. This was very beneficial to their economy. Now, foolishly, they have started taxing interest.

The Japanese businessmen went on to explain to us that it was University of Chicago economists who suggested that they build these incentives into their tax code. Here we are instructing our children not to squander their paychecks on instant gratification and to put something away for the rainy day, and if they do that we punish with multiple taxation.

Mr. **Kanaga**. As a matter of fact, I agree with those University of Chicago professors. As a matter of fact, these glasses may have been bought there, I am not sure. [Laughter.] But we have the most hostile environment for equity investment of any industrialized country in the world.

Mr. **Crane**. I couldn't agree with you more, Mr. Kanaga, and I hope you will keep hammering on that theme for the benefit of the tax raiders.

Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Kanaga, how do you account for the introduction of the capital gains tax in Japan to take effect in March 1989?

Mr. **Kanaga**. Sometimes the Japanese pick the wrong things to copy.

Chairman **Rostenkowski**. Mr. Sundquist.

Mr. **Sundquist**. Thank you, Mr. Chairman.

Mr. Kanaga, I noticed in Mr. Kirkland's testimony today he is talking about the pension problems that have occurred where employers, according to his testimony, have unilaterally terminated pension plans and used excess assets to fund mergers and acquisitions. And I noticed in your testimony that you are presently reviewing proposals to alter ERISA in this regard.

Could you comment particularly on the pension area as affected by LBO's, mergers, buyouts, that sort of thing, and what you would recommend, or when you plan on making these recommendations?

Mr. **Kanaga**. Well, there are two sides to the question. One is whether the pension plan assets should be used in LBO ventures. The other is what happens to the pensions in the companies that have been acquired. The recent statutes that have been enacted I think have really gone a long way toward protecting the money in the pension plans, and I think that that is wise. I think we have some substantial nonpension retirement benefits in the medical area that are considerable, and I would defend the pension assets from raids.

As far as investing those pension assets, I think the experience has been fine up till now. I think that we don't see any major problem. As a matter of fact, the consensus that we see is that there is not a high level of concern for the investment of pension assets in LBO.

Mr. **Sundquist**. Well, it seems from your testimony and Mr. Kirkland's testimony that you are coming, at least in one area, to the same conclusion. That conclusion is that workers whose pension benefits have been terminated by corporate raiders of corporations targeted have been left with annuities whose values are less than originally promised.

Mr. **Kanaga**. Yes. I think that the statute you passed have really stepped the protection up; that is, the penalty, the excise tax penalty on going after those.

Mr. **Sundquist**. Are you going to look at that again and come back with some further recommendations?

Mr. **Kanaga**. Yes. Right.

Mr. **Sundquist**. Thank you. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Are there any other members that would like to question? Mr. Guarini? Mr. Dorgan?

Mr. **Guarini**. Mr. Kanaga, at the present time corporations pay about 10 percent of our total internal revenue taxes, and I understand that the rest of it is paid by individuals. You have spent some time now telling us that we should give more tax breaks to corporations, and capital, and about double taxation and that you would have capital gains structured lower to 15 percent.

But I don't remember you saying very much about how this will help and benefit and eliminate the excesses in the LBO problem that we have, and I would like to ask you what regulation changes does the Chamber of Commerce have to make in regard to how we could better target our efforts and stopping the raiding that is happening that is detrimental to the economy of our country.

Where would you change the regulations, and what nontax matters would you address that the chamber stands for?

Mr. **Kanaga**. Well, first of all, on the tax side the benefits that we are proposing are to the individual taxpayer. We are talking about tax relief to the individual saver and investor on his dividend income, on his capital gains—on investment, encouraging investment in U.S. industries.

Mr. **Guarini**. Well, are you saying that the dividend should be a deduction of the corporation itself as it goes to the taxpayer?

Mr. **Kanaga**. Well, the——

Mr. **Guarini**. Then you are giving a tax break to the corporation.

Mr. **Kanaga**. How the dividend tax relief is given is not as significant as giving it. We would be perfectly, I would be perfectly in agreement with relief given to the recipient of the dividend rather than to payer.

Mr. **Guarini**. To do it by way of a tax credit instead of deduction to the corporation?

Mr. **Kanaga**. Yes.

Mr. GUARINI. You didn't make that clear. All right.

Mr. KANAGA. Right. And that is what is done in some countries, is the credit is given to the recipient, not to the payer.

Mr. GUARINI. Let's address the LBO, leveraged buyouts. What specific recommendations does the Chamber of Commerce have to alter the system that has been abusive?

Mr. KANAGA. Well, first of all, as we hear the testimony before you, we do not see major abuses. What we see, and I would personally, and let me speak personally—I would personally agree with the testimony that Mr. Ball gave about management buyouts, where the management with insider information makes a bid, which later he increases by, as in a recent case, almost 50 percent.

Mr. GUARINI. Then the Chamber is not disturbed about the fact that we are going more to debt than to equity. That the corporations of America are being very highly leveraged into debt, and this does not disturb the chamber of commerce.

Mr. KANAGA. Well, what we see is a level of debt which is significantly less than the debt 10 years ago, the level of debt against market value of equity 10 years ago. We do not see, and we are still significantly below the levels of our competition.

Mr. GUARINI. Well, in the past 5 years——

Mr. KANAGA. I am talking about Japan and Germany. Excuse me.

Mr. GUARINI. Yes. In the past 5 years, equity has declined over $300 billion, while debt has risen over $600 billion, by our corporations in America. Now that shows that there is a very strong swing from equity to debt, and this can't but help hurt and weaken our corporate structure in America. The chamber doesn't care about that?

Mr. KANAGA. We believe that it is not at an unmanageable level. And we believe that trying to micromanage the economy would be a mistake. We do not see that there have been any significant problems created, and we—that is, shy of a major recession in this country, we don't see a problem.

As a matter of fact, there is not such a thing as a risk-free investment. Anybody investing in those bonds, if they were investing in stock would face the same risk. The world is full of risks, and we see the present level as at a manageable figure.

Mr. GUARINI. May I just make the statement, Mr. Chairman, about 10 years ago we were 24 percent debt as compared to equity. Now we are about 46 percent debt as compared to equity. The swing has been very violent. The Chamber of Commerce doesn't take note of that or has no concern?

Mr. KANAGA. We can use all these figures. We are saying that we believe that it is manageable. It is still far less than Japan and Germany.

Mr. GUARINI. Where does it become worrisome to the Chamber of Commerce? At what point do we throw up a red flag?

Mr. KANAGA. What we see is a significant repayment level, if we look at the testimony of the firm from last week's Senate Finance, they have paid off over half of the $35 billion that they have incurred in the LBO's. And I believe that it has given new discipline to people. They do not carry loss operations without significant efficiencies being involved. And we just do not see that this management, that this debt level is at an unmanageable level.

Mr. GUARINI. Thank you.

Chairman ROSTENKOWSKI. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

When you say you don't see a problem, are you saying a problem doesn't exist or that you just don't see one?

Mr. KANAGA. We say that it is not at an unmanageable level, Mr. Dorgan.

Mr. DORGAN. You know I certainly respect your opinion, but it occurs to me it is almost impossible to read the business page of the major papers or read the Wall Street Journal and not see there is a powerful amount of greed driving a whole series of transactions that have nothing at all to do with good business. It has to do with greed and quick money. As you represent the productive sector of this country it seems to me you would be interested especially in the kind of climate that would promote long-term stable investment to produce the best products to compete most effectively in the international marketplace.

My understanding is there are no hostile takeovers occurring in Japan. If that is the case, should we ban hostile takeovers in order to more effectively compete with Japan?

Mr. KANAGA. Let me review some of what has happened during this period of debt buildup. We have created since 1982 some 19 million new jobs in this country. That is in the face of restructuring efficiencies, slimming down some companies that have bought and brought into effective management by newly found entrepreneurs. That 19 million is more than all of the rest of the industrial world put together. That is a very effective and startling record that we have had in this country.

And we believe that if we start tinkering—for one thing, probably the most highly leveraged companies are those that are privately held and small, the small businessman who has leveraged his business; he is expanding and the one way he can grow is to borrow. We just think that tinkering with the interest deduction will have a massive and adverse impact, and on all those small business members of the U.S. Chamber of Commerce. And we believe it should not be done.

Mr. DORGAN. I guess you and I are just reading different scoreboards. I don't think we are winning. I think we are losing. Look at the trade deficit.

At Christmas time a friend of mine was loading a Japanese television set in the trunk of his German car, apparently to take home a gift for Christmas. When he saw me, he said, "When are you guys down in Washington going to get everything straightened out?" As I drove away, I smiled a bit. Part of what needs straightening out is the kind of products we make to persuade that customer that that is the best product. If it is built here, it creates jobs here.

I am mindful that this is an international economy. If you speak to me as a person who represents an international economic enterprise, that is one thing. But if you speak to me as someone who represents a productive sector of this country, my observation is that, when you read the business news, we are not winning. We are playing games that are destined to cause us to lose even more in the future.

I guess I hope that we can find our way through to some public policies here to get us back on track. We need to tell American business, "Stop playing paper games". Do what is necessary to build and plan and invest for long run. You must build products a consumer somewhere halfway around the globe looks at and sees "Made in the USA," and understands that is a better product than the competing product. When you do that we win.

But I guarantee you the kind of people who are out there today swimming around in these shark-infested waters trying to find the next buck in the next hour, are not interested in what you and I are interested in. And I cannot understand how you fail to see a problem in those areas.

Mr. **Gibbons**. Would the gentleman yield?

Mr. **Dorgan**. Yes, sir.

Mr. **Gibbons**. I just want to interrupt for a minute. I agree with much of what you say, but as I recall, and perhaps I am wrong or my recollection is hazy, I think Japanese corporations are about the most highly leveraged corporations on earth. As I recall, they have a debt-equity ratio of about 90 percent debt and about 10 percent equity.

Mr. **Dorgan**. Reclaiming my time—you are absolutely correct. In Japan, those corporations will not fail because they are guaranteed by the federal government, and they are part of a combined public policy and private policy strategy for a managed trade and a managed business economy. We don't have that in this country.

If we get to the point where highly leveraged corporations in America are leveraged in order to protect themselves against hostile takeovers, find an economic down turn and find themselves in trouble, they will be at this table asking us for their help in order to avoid default.

Chairman **Rostenkowski**. Thank you very much, Mr. Kanaga.

Mr. **Kanaga**. Thank you. Thank you very much, Mr. Chairman.

Chairman **Rostenkowski**. Professor Warren. Dr. Jensen. Professor Auerbach. Professor Ribstein.

Welcome to the committee, gentlemen. We certainly appreciate your participation in these hearings. I am sure that we stand to benefit by some of your observations. I am hoping, of course, that you will feel free to get into a discussion any time you would like to help us write a record here for what I see, by the participation of the committee over the last several days, is a very large problem that I am hoping we can solve. And yet again, we are going to determine here whether or not it is a problem that is solvable.

So having said that, Professor Warren, why don't you begin, to be followed by Mr. Jensen, by Mr. Auerbach, and then Mr. Ribstein.

STATEMENT OF ALVIN C. WARREN, JR., PROFESSOR OF LAW, HARVARD LAW SCHOOL, CAMBRIDGE, MA

Mr. **Warren**. Thank you, Mr. Chairman. Rather than reading my prepared statement, I think I could be——

Chairman **Rostenkowski**. I would like to notify you, your entire statements will be included in the record. If you would like to summarize, fine.

Mr. **Warren**. Thank you. Rather than reading the statement, I think I could be most helpful to the committee by focusing on the tax incentives involved in these transactions. There are other experts on the panel who are more expert than I in the economic and financial aspects. What I would like to do is summarize the tax relationships in these transactions in five steps. You can think of it as a handy five-step guide to the underlying tax relationships.

The first step is to identify precisely the tax incentive that motivates the transactions under discussion. I would state it this way—under current law, simply by engaging in certain financial transactions, corporations can eliminate future corporate taxes on an existing corporate income stream without an offsetting shareholder tax, even where future payments of one tax or the other was reflected in the price paid for stock. The results of this incentive can include a diminution of the corporate tax base and possible windfall gains to some investors.

The second step is to identify the transactions that taxpayers can use to take advantage of that incentive. Some are obvious and some are not so obvious.

The most obvious transactions are debt-financed acquisitions, which have been discussed often in these hearings, with leveraged buyouts being the classic example. But a single corporation that is not involved in an acquisition can achieve exactly the same results through a debt-financed share repurchase or debt-financed distribution of an extraordinary dividend.

And least intuitively obvious of all, it is possible to take advantage of the incentive in current tax law without using debt finance. It is thus typical in these transactions to use debt finance, but it not necessary. For example, any time a corporation repurchases its own shares, even if it does not use borrowed money, it diminishes the corporate tax base.

Similarly, any time an acquiring corporation buys the stock of a target corporation from the target's individual shareholders there is a diminution of the existing corporate tax base.

Given the tax incentive and the relevant transactions, the third of my five steps is to notice that these are all taxable transactions to shareholders. For example, the selling shareholders are taxed in a leveraged buyout, a debt-financed share repurchase, and a debt-financed extraordinary dividend. So the third step is to ask why there is not an adequate offsetting shareholder tax in these transactions to compensate for the loss of the future corporate tax base.

In answering this question, it is important to keep in mind that we are talking about a present value calculation. By and large, in these transactions the corporate tax base is diminished forever or for a very substantial period of time. If there is going to be a compensating shareholder tax, it has to be a big tax and it has to be collected all at once when the selling shareholder pays taxes.

It is, however, extremely unlikely that we are going to collect an offsetting tax at that point for two reasons. The first reason is that, according to the Federal Reserve figures in the Joint Committee pamphlet for these hearings, almost half of corporate stock is in the hands of exempt pension funds, foreign shareholders, charitable organizations, or tax-advantaged insurance companies. So that at least with respect to those shareholders we are not going to collect much of a tax at all.

Second, even when we are talking about taxable shareholders, in most of these transactions shareholders are taxed only on their gain on the transaction, and the mathematical relationships are such that for us to collect a fully offsetting shareholder tax we have to collect a tax on the entire amount distributed, not just the shareholders gain. So the tax incentive exists in the transactions because the corporate tax base is reduced and is not offset by a collection of a fully offsetting shareholder tax.

My fourth step relates to how to think about these relationships. Because the problem involves both the diminution of a corporate tax and the failure to pick up an offsetting shareholder tax, there are three ways that this problem has been thought about.

One is to look at the corporate consequences and conclude that there has been a substitution of debt for equity, and therefore the solution should be some sort of limitation on the interest deduction where there is a substitution of debt for equity.

This response is accurate as far as it goes, but will not resolve the entire problem, in part because there are transactions where you can take advantage of the tax incentive without debt, and in part because any solution here is going to run into significant problems involving foreign competitors of U.S. corporations. In my judgment, a solution along these lines would respond to a symptom and not the underlying problem.

A second way of looking at these transactions is to focus on the failure to fully tax shareholders in these transactions. Thus it has been suggested in a number of proposals that the committee ought to strengthen the tax at the shareholder level, perhaps expanding the tax on exempt entities, or by adopting a minimum tax on distributions.

This way of looking at the tax relationships is somewhat broader than simply responding to debt-financed acquisitions because it would deal with all distributions, but, in my judgment, it is also responsive to a symptom rather than the underlying problem.

What then is the third way of looking at these issues, and the way that I would hope you would look at them? I would simply add my voice to those that you have heard stating that the underlying problem is the disparate treatment under our tax system of debt and equity. From this perspective, the problems under discussion could be solved by beginning the process of integrating our individual and corporate income taxes. Not only would the problems addressed in these hearings be solved, but a number of others would also be solved.

Let me just take 1 minute to say a word about integration. As you know, there are two ways of accomplishing it. You could either adopt a corporate deduction for dividends paid or a shareholder credit for corporate taxes paid with respect to dividends received.

I urge the committee to keep two things in mind if it thinks about integration as a solution to this problem.

First, any march down that road has to include very careful consideration of corresponding treatment for debt and equity at all times. To the extent we adopt integration and do not treat it the same as equity, we are simply going to recreate the problems under discussion today.

Second, if dividend relief is considered, the committee is going to have to face up to the question of whether the portion of the corporate income stream that goes to foreign and exempt investors such as pension funds and charitable entities should bear no tax whatsoever.

Our current system is that sometimes income earned through a corporate organization is taxed not at all, because it is paid out in the form of deductible interest, for example, and it goes to non-taxable foreign lenders. Other corporate income is taxed twice because it is taxed once at the corporate level and paid out in the form of dividends that go to taxable U.S. shareholders.

I would like to see us consider the consequences of a system where all corporate income is simply taxed once. Therefore, I urge the committee in the long run to consider adopting a shareholder credit system with something like withholding on interest payments. In the interim, the committee might want to consider a limitation on deductibility where debt is substituted for equity. Or finally, if we are moving toward integrating the corporate and individual income taxes with respect to dividends, it might be appropriate to enact a concomitant limitation on the deductibility of interest, as long as we are very careful that we are starting down the road of parallel treatment of both sorts of capital investment.

Finally, my fifth step is simply to say that all of my remarks just have to do with the tax incentives involved in these transactions. Removing the tax incentives here would only remove the tax system from subsidizing the transactions that we are talking about.

For those, and there are some on the panel, who believe that these transactions involve substantial efficiency gains for the American business community, the kinds of responses I have been talking about would simply level the playing field with respect to the tax system and would not interfere with the possibility of nontax efficiency gains through these transactions.

Thank you, Mr. Chairman.

[The statement of Mr. Warren follows:]

Recent Corporate Restructuring
and the Corporate Tax System

Statement of Alvin C. Warren, Jr.
Professor of Law, Harvard Law School

Hearings on Tax Policy Aspects of
Corporate Mergers, Acquisitions, Leveraged Buyouts,
and Recent Increases in Corporate Debt

Committee on Ways and Means
U.S. House of Representatives
February 1, 1989

Mr. Chairman and Members of the Committee:

I am pleased to appear before you today to discuss tax policy aspects of certain corporate mergers, acquisitions, and leveraged buyouts, as well as other recent increases in corporate debt.

I. The Problem from the Perspective of the Corporate Tax System

I would like to discuss recent corporate restructurings from the perspective of the corporate tax system. There are a great many other perspectives, both social and economic, that should be considered by the Committee, but it is also worth focusing separately on the tax system, because tax considerations have been urged both as a major determinant of the current situation and, concomitantly, as providing a potential means of legislative reaction. As might be expected, the tax relationships are themselves quite intricate, so I begin by trying to identify precisely the problem from the perspective of the tax system before discussing potential solutions.

A. The Transactions

In order to make concrete the phenomena under discussion, let me suggest four examples, which are intended to be illustrative, rather than exhaustive, of current transactions:

1. Using funds acquired in exchange for the issuance of low-grade ("junk") bonds, an acquiring corporation purchases the stock of a target corporation in either a hostile or a friendly takeover (a "leveraged buyout").
2. Using borrowed funds, an acquiring corporation purchases the assets of a target corporation, which subsequently liquidates (a "debt-financed asset acquisition").
3. A public corporation borrows funds that are used to purchase its own stock from shareholders (a "debt-financed share repurchase").
4. A public corporation borrows funds that are used to pay dividends to shareholders in excess of current earnings on equity (a "debt-financed extraordinary dividend").

B. The Problem for the Corporate Tax System

What exactly is the problem for the tax system exemplified by these transactions? In each case, debt has been substituted for equity in the capital structure of the continuing corporation,[1] leading to the common observation that corporate taxes have been eliminated because interest payments are deductible while dividend payments are not. While that observation is accurate as far as it goes, a more precise description of the problem requires consideration of two additional aspects of the four transactions described above: (1) the distribution to shareholders that occurs in each case may be a taxable transaction, and (2) the possibility that the capital markets may have reflected in share prices the double taxation of earnings on corporate equity (once when earned by the corporation and once when distributed to shareholders).

1. The Relevance of Shareholder Taxation: A full examination of these transactions from the perspective of the corporate tax system requires consideration of shareholder taxation as well as corporate taxation. If, for example, the immediate shareholder tax on the distribution in each transaction was equal to the present value of the corporate taxes saved, there might be no tax incentive to so substitute debt for equity. Equivalent tax treatment of such shareholder distributions and corporate retentions would, in fact, obtain if shareholder and corporate tax rates were always the same, and shareholders and corporations had the same investment opportunities.[2]

Alternatively, if, as was often the case before 1986, the shareholder tax rate on ordinary income were in excess of the corporate tax rate, there would be a tax incentive to retain, rather than distribute, corporate earnings. And if the shareholder tax rate on capital gains were lower than the tax rate on dividends, there would be a tax incentive to structure distributions in a nondividend form eligible for capital gains treatment, such as a share repurchase. Under the pre-1986 General Utilities doctrine,[3] distributions could also be used to escape corporate taxation of unrealized appreciation on corporate assets.

What effect did the Tax Reform Act of 1986 have on these relationships? Reduction of the shareholder tax rate below the corporate rate made retention of corporate earnings less attractive. At the same time, elimination of the capital gains preference reduced the tax advantage of nondividend distributions over dividends. Finally, repeal of the General Utilities doctrine eliminated the possibility of avoiding corporate taxes on previously accrued gain through shareholder distributions.

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1. Since the end of 1983, over $313 billion of net coporate equity has been retired while corportions have borrowed $613 billion. Joint Committee on Taxation, Federal Income Tax Aspects of Corporate Financial Structures 7 (JCS-1-89; January 18, 1989).

2. Consider a corporation with $100 in after-tax retained earnings, when corporate and shareholder tax rates are both 40 percent and the pre-tax rate of return is 10 percent. Investment of those retained earnings would yield $10 annually in pretax corporate income and, after paying corporate taxes, the corporation could annually distribute $6.00 in dividends to shareholders, who would retain $3.60 after paying shareholder taxes. Alternatively, the corporation could distribute the $100 of retained earnings in a taxable transaction, leaving shareholders with $60, which could be lent back to the corporation. Future interest payments would be deductible, generating $6 annually in interest payments to the debtholder, or $3.60 after debtholder-level taxes. For further discussion of these relationships, see American Law Institute, Federal Income Tax Project -- Subchapter C 348-352 (1982).

3. General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).

Thus, the four transactions described above would today reduce future corporate taxes at the cost of a full ordinary income shareholder tax, *if the shareholder were fully taxable on the distributed amount*. The underlined qualification is crucial to understanding the current relationships because if all shareholders were fully taxed on these distributions, the corporate tax benefits of the transactions would be reduced by the shareholder tax, with the former fully eliminated by the latter when the conditions for equivalence described above were fulfilled.

There are, however, several categories of shareholders who are not fully taxed on such distributions, including, for example, tax-exempt institutions and pension funds, foreign investors,[4] and shareholders with a high basis due to either recent purchases or testamentary transfers of shares.[5] The tax treatment of these shareholders is thus an important, central aspect of the current situation.[6] But before a full statement of the problem can be attempted, one additional factor must be taken into account: the possible effect of the corporate tax system on share values.

2. *The Possibility of Windfall Gains*: If corporate earnings can be distributed to shareholders only in a form that is fully taxable, then the capital markets might be expected to capitalize that future detriment in current share prices.[7] That is, an investor who acquired stock to which $100 of retained corporate earnings was allocable would pay less than $100 for the right to receive those earnings if he knew that the distribution would be taxed at the shareholder level. If such capitalization has in fact occured, a shareholder who receives the full $100 in one of the transactions described above without paying the expected shareholder tax will receive a windfall gain.

3. *Identifying the Problem*: Taking into account both corporate and shareholder taxation, as well as the possibility of market capitalization of taxes, the problem with the prototypical transactions described above from the perspective of the corporate tax system is that *simply by engaging in these transactions, corporations can eliminate future corporate taxes on an existing corporate income stream without an offsetting tax on shareholders*, even where future payment of one tax or the other was reflected in the price paid when shares were purchased. Elective elimination of corporate taxes in this manner may contribute to the economic and social concerns arguably

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4. Nonresident foreign shareholders are not taxed on U.S. capital gains that are not related to U.S. real estate or a U.S. trade or business. Internal Revenue Code of 1986, §§871(a), 897 (hereinafter "I.R.C."). Dividends to such shareholders are subject to a withholding tax of 30 percent, subject to reduction by treaty. I.R.C. §§871(a), 1441(a).

5. Assets received in testamentary transfers have a basis equal to fair market value at the time of the transferor's death. I.R.C. §1014.

6. At the end of 1987, 31 percent of outstanding corporate equities was held by foreign investors, pension funds, and life insurance companies, entities that are subject to favorable federal income tax treatment. The remainder, nearly 60 percent, was held by the household sector, which includes charitable organizations. In 1982, 83 percent of this household sector equity was owned by individuals. Thus, about half of corporate equities appear to be held by exempt or tax-favored investors. See Joint Committee on Taxation, *supra* note 1, at 13.

7. See, e.g., Auerbach, Wealth Maximization and the Cost of Capital, 93 *Q.J. Econ.* 433 (1979).

implicated by these transactions, such as overreliance on debt finance by U.S. corporations, reduction of U.S. corporate tax revenues, and social dislocations resulting from leveraged buyouts and other acquisitions. Because the problem identified here involves both corporate and shareholder taxes, it is subject to two, somewhat different, interpretations.

a. **Substitution of Corporate Debt for Corporate Equity is the Central Tax-System Problem.** Although the identified opportunity to eliminate the corporate tax can be availed of in debt-financed acquisition transactions involving two corporations (such as leveraged buyouts and debt-financed asset acquisitions), that opportunity can also be availed of in non-acquisition transactions involving a single corporation (such as debt-financed share repurchases and debt-financed extraordinary dividends). Thus a full solution to the problem from this perspective should address not only acquisition transactions, but also other distributions to shareholders where corporate debt is substituted for corporate equity. In addition to the nonacquisition transactions described above, a full solution would presumably also apply to share exchange programs that are designed to convert part of a shareholder's dividend into deductible interest.[8]

b. **Nontaxation of Shareholders on Distributions is the Central Tax-System Problem.** On this alternative view, the substitution of debt for equity in the four examples above is less important than the distribution of assets out of corporate solution without a full shareholder tax. The arguable primacy of the distribution tax can be seen by separating debt finance from distributions to shareholders. Suppose a corporation simply borrows to buy new equipment; that transaction does not remove assets from the corporate tax base, and does not therefore prospectively eliminate existing corporate taxes. On the other hand, the benefits of reducing corporate taxes through a share repurchase or an extraordinary dividend can be obtained without debt financing. A corporation can simply distribute retained earnings to a nontaxable shareholder in a share repurchase or extraordinary dividend, eliminating the future corporate tax without attracting a current shareholder tax. Similarly, an acquiring corporation can use its own liquid assets to purchase the stock of a target corporation from the target's noncorporate shareholders, thereby shrinking the existing corporate tax base. Using debt to finance a distribution in the transactions under discussion is thus typical, but not essential, to the tax advantage viewed from this perspective.

c. **Comparing the Two Views of the Central Tax-System Problem.** Both views suggest that there is a problem with the current corporate tax system when a distribution reduces net corporate assets without shareholder taxation; that is, when gross corporate assets are not diminished, but the portion financed by debt increases. The distributions view goes further to indicate that there is also a problem when gross corporate assets are reduced in a distribution that does not attract shareholder taxation. Consider the following extreme, paradigmatic case: an existing corporation that has been financed entirely by retained earnings liquidates and distributes all of its assets to shareholders who are not taxable on the transaction. Under the first view of the problem, there is no corporate tax base elimination issue to be addressed, because there will be no further corporate activity. There is, however, an issue under the second view because existing corporate taxes have been eliminated without a compensating shareholder tax. On this view, the government's continuing corporate-tax-base revenue claim on the now noncorporate income stream is founded on either historic practice or the related possibility of a windfall gain to shareholders.

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[8] See, e.g., Firms, Seeking to Raise Value of Shares, Plan to Restructure Stock, Wall Street Journal, p.1, December 6, 1988. (discussing "unbundled stock units").

d. **Implications for Possible Solutions:** If the general statement of the problem for the tax system identified above is accepted, it can be seen that there are three principal possibilities for legislative reaction -- limitations on the tax benefits of debt finance, additional taxation of corporate distributions, or reduction of the relative tax disadvantages of equity. Choices among these alternatives will depend in part on which, if either, view of the central tax-system problem is embraced, and the extent to which the capital markets are thought to have capitalized expected taxes in share prices. I will describe the principal advantages and disadvantages of each legislative approach, before indicating the course that I hope the Committee will follow.

II. Possible Legislative Solutions

A. Reducing the Tax Advantage of Debt

1. Proposals: Perhaps because the most publicized of the transactions under discussion, such as leveraged buyouts, have involved the substitution of corporate debt for equity, the most widely discussed legislative proposals have mandated additional restrictions on the deductibility of interest, in order to reduce the tax advantages of corporate debt over equity. Thus it has been suggested that all corporate interest deductions be eliminated,[9] that deductibility of acquisition-related interest be disallowed when corporate gain is not realized,[10] that interest deductions related to "excessive debt" (defined on an industry-wide basis) be disallowed in acquisition and related transactions,[11] that interest deductions be limited to cash payments,[12] that no deduction be allowed for interest on debt incurred to displace outstanding equity,[13] and that deductible corporate interest be limited to a rate defined in relation to an applicable federal rate.[14] These limitations, which are but a few of those that have been suggested,[15] have quite different, and sometimes conflicting, policy goals.[16]

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9. Bierman, Debt, Stock, and Junk Bonds, Tax Notes 1237 (December 12, 1988).

10. Omnibus Budget Reconciliation Act of 1987, H.R. 3545, 100th Cong., 1st Sess., §10138 (passed by the House, eliminated in Conference).

11. Canellos, The Over-Leveraged Acquisition, 39 Tax Lawyer 91 (1985).

12. Cf. I.R.C. §163(e)(3) (original issue discount on debt held by a related person not allowed as a deduction until paid).

13. The American Law Institute, Federal Income Tax Project, Tax Advisory Group Draft No. 17 (October 7, 1987).

14. Id.

15. For additional proposals, see Joint Committee on Taxation, supra note 1, at 103-112.

16. These goals include: distinguishing debt from equity, protecting the current corporate tax base, assuring that all corporate income is taxed at least once, assuring that some fraction of all corporate income is taxed twice (once at the corporate and once at the investor level), offsetting the failure to realize corporate gain on the transfer of shareholder interests, and adjusting the interest deduction for inflation.

2. Advantages: Proposals along these lines have the advantage of responding to the most acutely perceived part of the problem -- acquisitions and other transactions involving the substitution of debt for equity. Such proposals also build on familiar tax concepts, including the distinction between debt and equity, as well as existing, but not very effective, limitations on deductibility of interest on acquisition indebtedness.[17]

3. Disadvantages: There are, nonetheless, at least five significant disadvantages to simply enacting additional restrictions on interest deductibility as a targeted response to the transactions under discussion.

First, such restrictions raise significant implementation issues at their boundaries. Given the general description of the problem above, any limitation that applied only to acquisition transactions would be only a partial solution, leaving in place opportunities to eliminate corporate taxes in non-acquisition transactions. Extending the limitation to all debt-financed distributions would still be a partial solution on the view that nontaxable distributions are the central tax-system problem, because such a limitation would not apply to non-debt-financed transactions. But even if the distributions view is rejected, a limitation on interest related to debt-financed distributions would itself create significant implementation issues at the boundaries. For example, would the limitation apply to an acquiring corporation which used borrowed funds to purchase the assets of a target company that independently liquidated at some later date? Similarly, would a liquidation-reincorporation doctrine be necessary to deal with tax-free liquidations followed by the return of assets to corporate solution in exchange for debt? These issues, which arise when debt is not incurred simultaneously with a distribution, would be avoided by a limitation on all corporate interest deductions, but such a broad limitation would increase the cost of debt capital for all corporations, including those which have not taken advantage of the possibility of eliminating corporate taxes by making distributions to shareholders. A general limitation on all corporate interest deductions would thus be an overly broad reaction to the problem under discussion today and should be considered only in the context of general corporate tax reform.

Second, the very tax concepts on which interest limitation proposals build, most notably the distinction between debt and equity, are themselves among the most problematic and least satisfactory aspects of current corporate tax law.[18] Nondeductibility of interest would, for example, eliminate the need to distinguish nondeductible dividends, but create the need to distinguish deductible rent.

Third, the additional categories required by such proposals (such as "excessive" versus "nonexcessive" debt in a particular "industry") are likely to be extremely complicated to implement or, alternatively, simple but arbitrary in their application.

Fourth, applying new limitations to U.S. corporations might provide a relative advantage to acquisition of American companies by foreign corporations, if foreign jurisdictions did not impose similar restrictions.

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[17] I.R.C. §279.

[18] After decades of inconclusive judicial attempts to articulate a workable distinction between debt and equity, the Tax Reform Act of 1969 added section 385 to the Internal Revenue Code, specifically authorizing the promulgation of regulations on the distinction. The Treasury Department was unable to produce regulations until 1980, which regulations were finally withdrawn in 1983.

Fifth, restrictions on corporate interest deductions could dramatically adversely affect stock prices; that, at least, was the assertion of some observers after the House of Representatives passed legislation along these lines in 1987.[19]

B. Additional Taxation of Distributions

The second potential legislative response to elimination of corporate taxes through shareholder distributions focuses on shareholder taxation of those distributions, rather than on deductibility of corporate interest payments.

1. The ALI Draft Proposal: The Federal Income Tax Project of the American Law Institute is considering a proposal that would directly address the distributions version of the problem discussed above.[20] Distributions other than ordinary dividends would be subject to a minimum tax, which would be paid by the distributing corporation and creditable by the receiving shareholder against shareholder taxes otherwise due on the distribution. Thus, dividend and nondividend distributions of existing corporate assets would generally be subject to either a shareholder or corporate withholding tax. Certain returns of shareholder capital would be exempted. Portfolio investments in corporate stock by corporate shareholders would bear a correlative burden through denial of the intercorporate dividend deduction.

A related, but separable, proposal would permit the deduction of dividends, up to a specified amount, paid on newly-contributed equity, so that returns on future corporate financing would be treated equivalently, whether the financing took the form of debt or equity.

a. **Advantages:** The ALI draft proposal directly addresses the problem described above if distribution taxation is considered the central issue. Corporate taxes could no longer be eliminated through nontaxable corporate distributions, because the distribution would be taxable, whether or not financed with debt, and whether or not part of an acquisition transaction. Windfall gains would be prevented, and nondividend distributions to otherwise nontaxable shareholders would bear a tax by virtue of the nonrefundable corporate minimum tax on distributions.

b. **Disadvantages:** For some observers, the ALI draft proposal for a minimum tax on distributions has the defect of appearing to add a third tier of tax to the corporate tax system, which already includes corporate and shareholder income taxes. The shareholder credit and a sufficiently broad exemption for return of capital should help alleviate this concern. For other observers, the ALI draft proposal goes too far because they see no need to preserve or capture a future corporate tax if distributed corporate assets are not returned to corporate solution through debt finance.

c. **The Need for Basic Corporate Tax Reform:** For myself, the ALI draft proposal's principal strength -- a direct attack on one version of the tax-system problem under discussion in these hearings -- is also its principal drawback, because the proposal takes so much of the current regime as given. Like limitations on interest deductibility, the draft proposal would add considerable new machinery to an already complicated system

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19. Action Uncertain on Leveraged Buyouts, Tax Notes 144 (January 9, 1989).

20. The American Law Institute, Federal Income Tax Project, Tax Advisory Group Draft No. 18 (November 3, 1988). These proposals are in the process of formulation and do not necessarily represent the position of the Institute.

without fundamentally reforming corporate and shareholder taxation. My own view is that such reform is badly needed; this view is presumably also reflected in the Congressional mandate in the Tax Reform Act of 1986 for a Treasury Department report on comprehensive corporate tax reform. The problem under discussion in these hearings is but one symptom of the need for such reform.

An example of the limitations of the ALI draft proposal is the result that dividends and nondividend distributions to tax-exempt entities with respect to existing corporate equity would generate a corporate-level tax, but corporate interest payments would not. Similarly, corporate earnings currently distributed to exempt shareholders would give rise to only a corporate income tax, whereas retained earnings distributed in a nondividend transaction would, in addition, be subject to the new minimum tax. These distinctions seem more easily justified as preserving and refining the current regime than as appropriate under some normative view of what the corporate tax system should be. An implicit normative premise can be derived from the proposals -- that the corporate tax base should be limited to the return on existing equity plus the excess of earnings on new capital over a specified rate of return -- but that premise is neither intended by the project (which is directed only at refining the current regime) nor the most obvious premise on which to base fundamental reform.

2. Other Proposals for Taxing Distributions: Because of the importance to the issue under discussion of shareholders who are nontaxable on certain corporate distributions, another approach would be to reduce existing opportunities for less than full taxation of shareholders. Examples would include expanding the scope of the unrelated business income tax as applied to charitable institutions, taxing certain investment income of pension funds, eliminating the step-up in basis of assets at death, and strengthening U.S. taxation of foreign shareholders and debtholders of U.S. corporations. Similarly, the importance of the rate relationships discussed above indicates that pressures for corporate distributions would be reduced if the shareholder tax rate were again higher than the corporate rate. While some or all of these ideas may be desirable on their own merits, their implementation, like the ALI draft proposal and limitations on interest deductibility, would leave unfinished much needed basic reform of the corporate and shareholder income taxes.

C. Reducing the Tax Disadvantage of Equity

1. Integration Proposals: The third principal means of eliminating the problem identified above is to reduce the tax disadvantage of new equity finance by integrating the individual and corporate income taxes. In very general terms, such integration could be accomplished by allowing either a corporate deduction for dividends or a shareholder credit for corporate taxes paid with respect to distributed earnings.[21] The House of Representatives version of the Tax Reform Act of 1986 included a phased-in partial deduction for dividends.[22] Under either dividend deduction or shareholder credit integration, the corporate tax would become a withholding tax on distributions to suppliers of corporate capital, functioning as an adjunct to shareholder or debtholder taxation.

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21. See generally, C. McLure, Must Corporate Income be Taxed Twice? (1979); Warren, The Relation and Integration of Individual and Corporate Income Taxes, 94 Harv. L. Rev. 717 (1981).

22. Tax Reform Bill of 1985, H.R. 3838, 99th Cong., 2nd Sess. §311.

3. Advantages: Integration is a massive subject that has long been on the agenda of the Congressional tax-writing committees and various Administrations. Adoption of an integrated system would eliminate many of the defects in our corporate tax system, including the one under discussion, in part because debt would no longer be treated significantly differently from equity. The ability to avoid future corporate taxes by making nontaxed nondividend distributions would be eliminated to the extent such distributions were subject to the shareholder credit mechanism.

Integration would subject U.S. companies to a tax regime that was similar to that of many other industrialized nations, a number of which have implemented partial integration systems in recent years. Finally, integration, particularly of the shareholder credit variety, would permit explicit Congressional decisions about the appropriate treatment of distributees who might not otherwise be taxable. If, for example, it were decided that charitable institutions, pension funds, and foreign shareholders should be taxed on corporate distributions, the shareholder credit could be made nonrefundable. In short, integration is the most ideal long-run solution to both the particular problem before the Committee and the urgent need to reform the corporate tax system more generally.

3. Disadvantages: Like many long-run solutions, integration has certain short-run disadvantages. For example, immediate, full enactment of a dividend deduction or a shareholder credit would undoubtedly generate significant revenue losses. Such an enactment might also allow current shareholders to reap the full benefit of any windfall gains due to capitalization of taxes. But there is no need to enact integration in one fell swoop. It could easily be phased in, as was the 1985 House legislation. And the possibility of positive windfall gains in the stock markets may well give the Committee more flexibility to consider enacting limitations on certain interest deductions, which could have the opposite effect on share prices if enacted by themselves.

III. What Should the Committee Do?

The Committee has three principal choices if it wishes to legislate with respect to the opportunity under current law for corporations to eliminate corporate taxes by engaging in the transactions under discussion in these hearings.

First, it could simply propose additional limitations on the deductibility of corporate interest, either in general or for indebtedness related to certain acquisitions and distributions. The most widely discussed such limitations would solve only the most apparent aspects of the problem as identified above, and, by themselves, would do nothing to begin the process of more fundamental reform. Moreover, any new limitations would likely involve novel distinctions that would be difficult to apply and might well have an adverse impact on share prices and the relative position of U.S. companies in competitive international markets. I urge the Committee to consider a more far-reaching legislative response.

Second, the Committee could propose a new corporate tax on distributions, creditable at the shareholder level as suggested by the ALI Federal Income Tax Project, and perhaps coupled with a partial deduction for dividend payments with respect to new equity contributions. This solution is definitely preferable to limiting interest deductibility, if the Committee accepts the view that the central tax-system problem relates to elimination of future corporate taxes through nontaxable distributions, whether or not debt-financed.

But I hope that the Committee will go further and develop an approach to the problem addressed by these hearings that will lead forward to a more general, and much needed, reform of corporate and shareholder taxation. Thus, the third, and preferable, approach would be to begin the process of integration by enacting a partial, phased-in corporate dividend deduction or shareholder credit for corporate taxes. At the same time, the Committee might consider limitating interest deductibility in certain cases, such as those involving the substitution of debt for equity. It might well be that the contrary effects of those proposals on share prices would cancel each other out to a significant degree.

To the extent the role of the corporate income tax were reduced to that of a withholding tax, it would seem entirely appropriate to consider making this tax nonrefundable to exempt entities, such as charitable institutions and pension funds, because to that extent there would no longer be a separate corporate-level tax on that income. Credits could also be made nonrefundable to foreign shareholders, subject to our treaty obligations and the treaty negotiation process.

It would probably be easiest to accomplish these results, as well as equivalent treatment of debt and equity, in a shareholder credit system that also required withholding on corporate interest payments, coupled with a nonrefundable credit for nontaxable debtholders.[23] To the extent of integration, the result would be that all income earned on corporate assets, however financed, would always be taxed once, a result that is certainly not achieved today. Such a regime might well not have the negative revenue implications generally associated with integration. There would, of course, be important design issues to be resolved in treating debt and equity equivalently, including the appropriate taxation of financial intermediaries.

The details of the particular legislative solution are, however, less important than the concern that the solution adopted by the Committee be responsive to both the immediate problem that stimulated these hearings and the longer-term need for corporate tax reform. Issues related to these hearings that I have not had time to discuss, such as the use of ESOP's and assets with built-in gain in acquisitions would, of course, be addressed in any general reform of corporate and shareholder taxation.

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[23] Shareholder credit integration has exactly the same effect as a dividend or interest deduction, coupled with withholding. See Warren, supra note 21, at 775-777.

STATEMENT OF MICHAEL C. JENSEN, PH.D., EDSEL BRYANT FORD PROFESSOR OF BUSINESS ADMINISTRATION, HARVARD BUSINESS SCHOOL, CAMBRIDGE, MA

Mr. JENSEN. Yes, sir. I am happy to be here today. I would like to focus my remarks primarily on the real effects of leveraged buyouts. LBO's, of course, are only one part of a large amount of restructuring going on in the economy.

It is important for us to understand that these leveraged buyouts are, in fact, the procedures by which we are moving a substantial part of corporate America from one organizational form to a quite different organizational form. I have sketched that argument out in the written testimony and I will come back to it if it seems useful in the discussion period.

Let me summarize for you the empirical evidence on LBO's that has been gathered in a number of scientific studies. The studies cover all LBO's which occurred in the period 1979 to 1985. Some of it has been done at my alma mater, the University of Chicago.

First, the debt in these LBO firms starts out at about 20 percent of the total value of the enterprise. After the transaction it is 88 percent of total value. Virtually all of these transactions are friendly and almost all of them, and unlike the RJR Nabisco transaction which hit the headlines recently, involve the same management that were there before.

We find in the 3-year period following the buyout, 42 percent increases in operating earnings. Now when those are adjusted for industry and business conditions, it drops to about 25 percent. I think the earnings increases are higher in the recent transactions.

Net cash flows increased by 90 percent, 80 percent when adjusted for business cycle and industry conditions. Not only do we find these raw increases in the numbers, but the profit margins rise, productivity as measured by sales per employee rises, working capital is more efficiently managed, inventories are more efficiently managed, receivables are more efficiently managed. There doesn't seem to be any delays that we can measure in the payments to suppliers. There are assertions that some of the gains in LBO's come from such delayed payments.

There doesn't seem to be any unwise scrimping in expenditures on maintenance, repairs and advertising. Those expenditures as a fraction of sales stay constant after the buyout. So, in fact, these companies are not being cut to the bone in a shortsighted way.

R&D expenditures are a major point of concern. It turns out that only seven of these firms engaged in any R&D expenditures. Firms that are in the R&D business do not make good candidates for leveraged buyouts. You would not want to leverage a Silicon Valley company with 90 percent debt, and it isn't done, intentionally at least.

What about value increases? We find that value increases 110 percent from the time prior to the buyout announcement through the final resale or initial public offering after the buyout. A little less than half of that goes to the pre-buyout public shareholders. A little more than half of that gain goes to the managers and investors that are involved in the buyout.

Surprisingly, given what we read in the newspapers today, and there have been several studies of this, we find no systematic evidence that the bondholders lose in these transactions. That doesn't say that there are never cases where the bondholders lose. But there are as many cases where they win as when they lose.

The RJR Nabisco bondholders did experience losses, but the losses have been vastly exaggerated in the press. They amount to about $295 million, not $1 billion. And they should be compared to the $12 billion plus total shoreholder gains that were generated in that transaction.

Those bondholder losses are not going to be a problem because they are easily resolvable by covenant protections, "poison puts," which the Met could have negotiated in that contract if they thought it was a serious risk, and which I am sure they will pay very careful attention to in the future.

I think we should be careful not to feel sorry for people who didn't want to give up some yield in order to get those protections in the bond covenants. They took the risk, and on walking out of the casino after having lost the gamble are asking to be paid back.

We find no reductions in employment, on average, following these transactions. In fact, the numbers show that the median change in employment is positive, but employment in these firms is growing at a lower pace than their industry counterparts. It isn't that nobody is being laid off. Oftentimes many middle managers in bloated corporate staffs are being laid off. They are however, being replaced elsewhere in the organization. There is no evidence that employment is not falling.

We might, just to keep these facts in perspective, remember that in the period 1981 to 1987 General Electric Corp., reputed to be one of the best managed companies in the country, decreased its employment from 400,000 to 300,000. Over the last 10 years General Motors has cut its employment from 1 million to 750,000, and 125,000 of that came in the last 3 years.

The tax payments by LBO's are a major source of controversy. There are assertions in the press that the LBO's are being funded by the Treasury. Well, it is true, if you look at the data, that one-half of these companies pay no Federal taxes in the year following the buyout. Somewhat surprisingly, however, is that by the third year after the buyout because of the huge increases in earnings that are going on and the partial repayment of debt, the tax payments to the Federal Treasury are back to the level they were just prior to the buyout.

My best estimate is that on an annual basis Treasury revenues are increasing by about 60 percent as a result of these deals. Our estimates are based on the numbers on what actually happens in these buyouts and adjusting for the fact that some of the institutions holding both the stock and receiving the interest are tax exempt.

Now most of that tax increase is front end loaded. It turns out that Treasury gains about—well, by somewhat over 200 percent in the year after the buyout. It is going to be a very unusual deal when you take into account all of the tax effects where the Treasury loses. I have made a conservative estimate of what the RJR tax revenue effects are. In the RJR case, we have taxable capital gains of over $13 billion. Now it is true a bunch of that is held by nontaxable institutions, and more of it is going to be held by nontaxable institutions when the firm is resold in the future. Our best estimates, and I think they are pretty conservative, are that the Treasury tax revenues are going to increase from all sources due to this transaction, in the year after the buyout by about $3.25 billion. Now that should be compared to the $370 million that RJR Nabisco paid in Federal taxes in the year prior to the buyout.

Now there is a concern about whether all of this up front increase in tax revenues is going to be paid for by what the Treasury loses in the future. It turns out that using a 10 percent interest rate—which I think is high—the present value of those tax increases in excess of the tax losses are about $3.75 billion, so they are even higher than the first-year effects. The Treasury doesn't lose in the long run.

We can find individual deals, for example, with the Metropolitan in the case of RJR Nabisco where there are individual parties who have lost. In all of the corporate control activity that I have been studying for a number of decades now, the LBO's are the cleanest case where it is very hard to find any evidence of a problem. There is some turnover in the middle management and in the top level management, but it is very hard to find the problems that the press asserts exist in these deals.

There is a bias in the Tax Code that pushes us toward the use of debt. I am in favor of eliminating that bias, but not at the cost of tinkering with the tax deductibility of interest. We ought to eliminate the double taxation of dividends, and I would urge you to do that, and to start now.

I think that there is an unrecognized and very important benefit down the road to doing that. You won't get the support of many of the CEO's of corporate America, because they don't want to be pressured to pay out additional capital which is now trapped inside these organizations and being used inefficiently. That is one of the major reasons why these transactions are taking place.

Freeing up this double tax on dividends would make it easier for that trapped equity to come out. Getting it back into the hands of productive parties, into the venture capital market and elsewhere will generate nontrivial increased revenues as well as increased productivity and competitiveness.

And finally, there is another thing that can be done—although it isn't the domain of this committee. We should be taking a careful look at the bankruptcy laws to try and limit the tendency of the courts to rewrite the priority of claims. This makes bankruptcy a much more expensive process than it need be. The increasing debt that frightens us all a little bit, we now understand has very strong positive productivity effects. We have been taught that by our foreign competitors, and I don't think we have a choice but to move along in this direction.

Thank you very much.

Chairman ROSTENKOWSKI. Thank you, Dr. Jensen.

[The statement of Dr. Jensen follows:]

The Effects of LBOs and Corporate Debt on the Economy:

Remarks before the House Ways and Means Committee

Washington, DC, February 1, 1989

Michael C. Jensen
Edsel Bryant Ford Professor of Business Administration
Harvard Business School

Introduction

The corporate sector of the U. S. economy has been experiencing major change, and the rate of change continues as we head into the last year of the 1980's. Over the past two decades the corporate control market has generated considerable controversy, first with the merger and acquisition movement of the 1960s, then with the hostile tender offers of the 1970s and the leveraged buyouts and leveraged restructurings of the 1980s. The controversy has been renewed recently with the not yet completed $25 billion KKR leveraged buyout of RJR-Nabisco, a transaction almost double the size of the Chevron purchase of Gulf oil in 1985 for $13.2 billion (the largest completed corporate control transaction to date). These transactions are the most visible aspect of a much larger phenomenon that is not yet well understood. In spite of the controversy that surrounds them, and the fact that they are not all productive, these transactions are the manifestation of powerful underlying economic forces that, on the whole, are productive for the economy. Thorough understanding is made difficult by the fact that change, as always, is threatening, and in this case the threats disturb many powerful interests. One popular hypothesis offered for the current activity is that Wall Street is engineering transactions to buy and sell fine old firms out of pure greed. The notion is that these transactions reduce productivity, but generate high fees for investment bankers and lawyers. The facts do not support this hypothesis.

There has been much study of corporate control activity, and although the results are not uniform, the evidence indicates control transactions generate value for shareholders and that this value tends to come from real increases in productivity, not wealth transfers from other parties such as creditors, labor, government, customers or suppliers.[1]

The causes and consequences of takeover activity in the U. S. have been analyzed elsewhere.[2] My purpose now is to outline an explanation of the fundamental underlying cause of this activity that has to date received no attention. I propose to show how corporate control activity is part of a broader set of phenomena, to provide perspective on how LBOs, restructurings and increased leverage in the corporate sector fit into the overall picture, and to discuss some reasons why high debt ratios and insolvency are less costly now than in the past. Because of its topical relevance, I pay particular attention to LBOs and their role in the rejuvenation of competitiveness in the American corporation.

Active Investors and Their Importance

The role of institutional investors and financial institutions in the corporate sector has changed greatly over the last 50 years as institutions have been driven out of the role of active investors. By *active investor* I don't mean one who indulges in portfolio churning. I mean an investor who actually monitors management, sits on boards, sometimes is involved in dismissing management, often is intimately involved in the strategic direction of the company, and on occasion even manages. That description fits Carl Icahn, Irwin Jacobs and Kohlberg, Kravis, Roberts (KKR) well. Before the mid-1930s, investment banks and commercial banks played a much more important role on boards of directors, monitoring management, and occasionally engineering changes in management. At the peak of their activities, J. P. Morgan and several of his partners served on the board of directors and played a major role in the strategic direction of many firms.

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[1] For the argument that takeover gains to shareholders come from wealth redistribution from other parties see Schleifer and Summers (1988). No evidence has yet been produced that supports this argument. Jensen and Ruback (1983) and Jarrell, Brickley, and Netter (1988) survey the evidence on the effects of control related transactions. Lichtenberg and Siegel (1987) analyze Census data on 18,000 plants in the U.S. manufacturing sector in the period 1972-81 and find that changes in ownership significantly increase productivity.

[2] Jensen (1986, 1988)

Bankers' roles changed over the past 50 years as a result of a number of factors. One important source of this change is laws established in the 1930s that increased the costs of being actively involved in the strategic direction of a company while simultaneously holding large amounts of its debt and equity. For example, under the definitions of the 1934 SEC Act an institution or individual is an insider if it owns more than 10% of the shares of a company, serves on its board of directors, or holds a position as officer. Moreover, the 16-b Short Swing Profit Rules in the SEC act require an institution satisfying any insider conditions to pay to the company 100% of the profits earned on investments held less than six months. Commercial bank equity holdings are significantly restricted and Glass Steagall restricts bank involvement in investment banking activities. The Chandler Act restricts the involvement by banks in the reorganization of companies in which they have substantial debt holdings. In addition, the 1940 Investment Company Act put restrictions on the maximum holdings of investment funds. These factors are consistent with the empirical fact that money managers do not serve on boards today, and seldom think of getting involved in the strategy of their portfolio companies.

The restrictive laws of the 1930s were passed after an outpouring of populist attacks on the investment banking and financial community, exemplified by the Pecora hearings of the 1930s and the Pujo hearings in 1913. Current attacks on Wall Street are reminiscent of that era.

The result of these political and other forces over the past 50 years has been to leave managers increasingly unmonitored. Currently when the institutional holders of over 40% of the equity in this country become dissatisfied with management, they have few options other than to sell their shares. Managers' complaints about the churning of financial institutions' portfolios ring hollow: One can guess they prefer the churning system to one in which those institutions actually have direct power to correct a management problem. Few CEOs look kindly on the prospect of having institutions with substantial stock ownership sitting on their corporate board. That would bring about the monitoring of managerial activities by people who more closely bear the wealth consequences of managerial mistakes and who are not beholden to the CEO for their jobs. As financial institution monitors left the scene in the post-1940 period, managers commonly came to believe companies belonged to them and that stockholders were merely one of many stakeholders the firm had to serve.[3] This process took time, and the cultures of these organizations slowly changed as senior managers brought up in the old regime were replaced with younger managers.

The banning of financial institutions from fulfilling their critically important monitoring role has resulted in major inefficiencies. The increase in agency costs appears to have peaked in the mid to late 1960s when a substantial part of corporate America generated large cash flows but had few profitable investment projects. These firms launched diversification programs that led to the assembly of conglomerates, a course since proven to be unproductive. The fact that takeover and restructuring premiums regularly average about 50% indicates managers have been able to destroy up to 30% of the value of the organizations they lead before facing serious threat of disturbance. This destruction of value generates large profit opportunities, and the response to these incentives is the creation of innovative financial institutions to recapture the lost value. Takeovers and LBOs are among the products of these institutions. My estimates indicate that over the 10 years from 1975 to 1986, corporate control activities alone created more than $400 billion in value for investors.[4]

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[3] Even the most voracious maximizer of stockholder wealth cares about the constituencies of the corporation. Value maximizing implies the corporation should expend resources (to the point where marginal costs equal marginal benefits) in the service of customers, employers, communities, and other parties who affect firm value by influencing the terms on which they contract with the organization or through the threat of restrictive regulation or decline in reputation. If this is the meaning of "stakeholder theory" there is no conflict with value maximization as the corporate objective.

[4] Jensen (1988)

Along with the takeover specialists came other new financial institutions such as the family funds (the Bass Brothers, Pritzkers, and Bronfmans) and other institutions such as Warren Buffet's Berkshire Hathaway who figured out ways to bear the cost associated with insider status. Coniston Partners is another version of this new organizational response to the monitoring problem, and so is the Lazard Freres Corporate Partners Fund. These new institutions have discovered ways different from those of J. P. Morgan to resolve the monitoring problem. They purchase entire companies and play an active role in them; in fact, they often *are* the board of directors. The modern trend toward merchant banking in which Wall Street firms take equity positions in their own deals is another manifestation of this phenomenon. KKR is much more than an expediter of LBO transactions. It plays an important role in management after the transaction. In general, LBO specialists control the boards of directors in the companies they help take private. They choose the managers of the firm and influence the corporate strategy in important ways. Buyout specialists are very different from the usual outside or public directors that supposedly represent shareholders. *Buyout specialists own or represent in their buyout funds an average of* 60% of the firm's equity (see Kaplan [1988]) and therefore have great incentive to take the job seriously, in contrast to public directors with little or no equity interest.

The development of new financial institutions as a response to problems caused by the lack of effective monitoring of corporate managers continues to grow. Such innovation is likely to continue unless handicapped by new legislation, tax penalties or unfavorable public opinion. The attack on Wall Street and investment bankers that has been progressing in recent years may be the modern equivalent to the populist attacks in the decades prior to 1940 that led to the crippling of American corporations in the 1960s and 1970s.

The LBO Association: A New Organizational Form

It is instructive to think about LBO associations such as KKR or Forstman-Little as new organizational forms — in effect a new model of general management. These organizations are similar in many respects to diversified conglomerates or to Japanese groups of firms. It is noteworthy that the corporate sectors in Japan and Germany are significantly different from the American corporate model of diffuse ownership monitored by public directors. In both these economies, banks and associations of firms are more important than in the U.S. Indeed, one way to see the current conflict between the Business Roundtable and Wall Street is that Wall Street is now a direct competitor to the corporate headquarters office of the typical conglomerate.[5] Moreover, the evidence on the relative success of the *active investor* versus the *public director* organizational form seems to indicate that many CEOs of large diversified corporations have no future in their jobs; one way or the other many of those jobs are being eliminated by competition in the organizational dimension.

LBO associations such as KKR are one alternative to conglomerate organizations and, judging from their past performance, they apparently generate large increases in efficiency. Fig. 1 illustrates the parallels and differences between these organizational forms. LBO associations, portrayed in the bottom of the figure, are run by partnerships instead of the headquarters office in the typical large multi-business diversified corporation. These partnerships perform the monitoring and peak coordination function with a staff numbering in the tens of people, and replace the typical corporate headquarters staff of thousands. The leaders of these partnerships have large equity ownership in the outcomes and direct fiduciary relationships as general partners to the limited partner investors in their buyout funds.

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[5] A point originally made by Amar Bhide, Harvard Business School

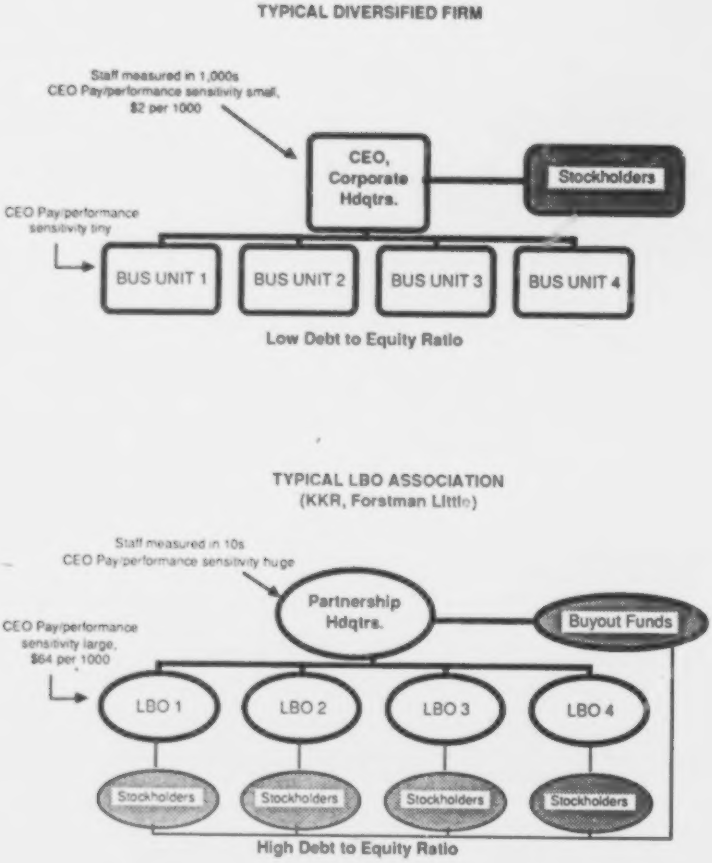
TYPICAL DIVERSIFIED FIRM
Staff measured in 1,000s
CEO Pay/performance sensitivity small,
$2 per 1000
CEO,
Corporate
Hdqtrs.
Stockholders
CEO Pay/performance
sensitivity tiny
BUS UNIT 1
BUS UNIT 2
BUS UNIT 3
BUS UNIT 4
Low Debt to Equity Ratio
TYPICAL LBO ASSOCIATION
(KKR, Forstman Little)
Staff measured in 10s
CEO Pay/performance sensitivity huge
Partnership
Hdqtrs.
Buyout Funds
CEO Pay/performance
sensitivity large,
$64 per 1000
LBO 1
LBO 2
LBO 3
LBO 4
Stockholders
Stockholders
Stockholders
Stockholders
High Debt to Equity Ratio

Fig. 1

Schematic representation of the correspondence between the typical diversified firm and the typical LBO association which are competing organizational forms. The LBO association is headed by a small partnership organization that substitutes compensation incentives (mostly through equity ownership) and top-level oversight by a board with large equity ownership for the large bureaucratic monitoring of the typical corporate headquarters.

The LBO partnerships play a role that is similar in many ways to that of the main banks in the Japanese groups of companies (commonly known as keretsu). The banks (and LBO partnerships) hold substantial amounts of equity and debt in their client firms and are deeply involved in the monitoring and strategic direction of these firms. Moreover, the business unit heads in the typical LBO association, unlike those in Westinghouse or GE, also have substantial equity ownership that gives them a pay-to-performance sensitivity which is on average 32 times higher than the average corporate CEO.[6] The average CEO in the Kaplan sample of LBOs receives

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[6] See Kaplan (1988) and Jensen and Murphy (1988).

$64 per $1,000 change in shareholder wealth from his 6.4% equity interest alone. The typical corporate CEO, however, is paid in a way that is insensitive to performance as measured by changes in CEO wealth. The average CEO in the Forbes 1000 firms in the Jensen and Murphy (1988) study receives total pay (including salary, bonus, deferred compensation, stock options and equity) that changes about $2 per $1,000 change in stockholder value.

The proper comparison of the functional form of the compensation package of the conglomerate CEO is not with the CEOs of the LBOs, but with the Managing Partner or Partners of the Partnership Headquarters. Little is publicly known about the compensation plans of the Partnerships, but the pay-to-performance sensitivity (including ownership interests, of course) appears to be large relative to that of the LBOs. The effective ownership interest in the gains realized by the buyout pool generally runs about 20% for the general partners as a group. LBO business unit heads also have far less bureaucracy to deal with, and far more decision rights in the running of their businesses. In effect, the LBO association substitutes incentives provided by compensation and ownership plans for the direct monitoring and often centralized decision making in the typical corporate bureaucracy. The compensation and ownership plans make the rewards to managers highly sensitive to the performance of their business unit, something that infrequently occurs in major corporations.[7]

In addition, the contractual relation between the partnership headquarters and the suppliers of capital to the buyout funds is very different from that between the corporate headquarters and stockholders in the diversified firm. The buyout funds are organized as limited partnerships where the managers of the partnership headquarters are the general partners in these funds. Unlike the diversified firm, the contract with the limited partners denies partnership headquarters the right to transfer cash or other resources from one LBO business unit to another. Generally all cash payouts from each LBO business unit must be paid out directly to the limited partners of the buyout funds. This reduces the waste of free cash flow that is so prevalent in most diversified corporations.

High Leverage and the Privatization of Bankruptcy

One important and interesting characteristic of the LBO organization is its intensive use of debt. The debt-to-value ratio in the business units of these organizations averages close to 90% on a book value basis (Kaplan (1988)). LBOs, however, are not the only organizations that are making use of high debt ratios. Public corporations are also following suit as witnessed by recapitalizations, highly leveraged mergers, and stock repurchases. There has been much concern in the press and in public policy circles about the dangers of high debt ratios in these new organizations. High debt has benefits as a monitoring and incentive device, especially in slow-growing or shrinking firms. What is not generally recognized is that the costs of insolvency, the situation in which a firm cannot meet its contractual obligations for payments, are likely to be much smaller in the new world of high leverage ratios than they have been historically. The reason is illustrated in Fig. 2.

In a world of 20% debt-to-value ratios (based on the going concern value of a healthy company), liquidation or salvage value is much closer to the face value of the debt than in the same company with an 85% debt/value ratio.[8] Fig. 2 shows a company under these two leverage ratios, and assumes that the salvage or liquidation value of the assets is 10% of the going concern value or $10 million. Thus, if the company experiences such a decline that it cannot meet its payments on $20 million of debt, it is also likely that its value is below its liquidation value. An identical company with an 85% debt ratio, however, is nowhere near liquidation when it experiences times sufficiently difficult to cause it to be unable to meet the payments on its $85 million of debt. That situation could occur when the company still has total value in excess of $80 million. In this case there is $70 million in value that can be preserved by resolving the insolvency problem in a fashion that minimizes the value lost through the bankruptcy process. In the former case there may be so little value left that the economically sensible action is liquidation, with all its attendant conflicts and dislocation.

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[7] See Baker, Jensen and Murphy (1988) and Jensen and Murphy (1988).

[8] I am indebted to Mark Wolfson for helping me see this point.

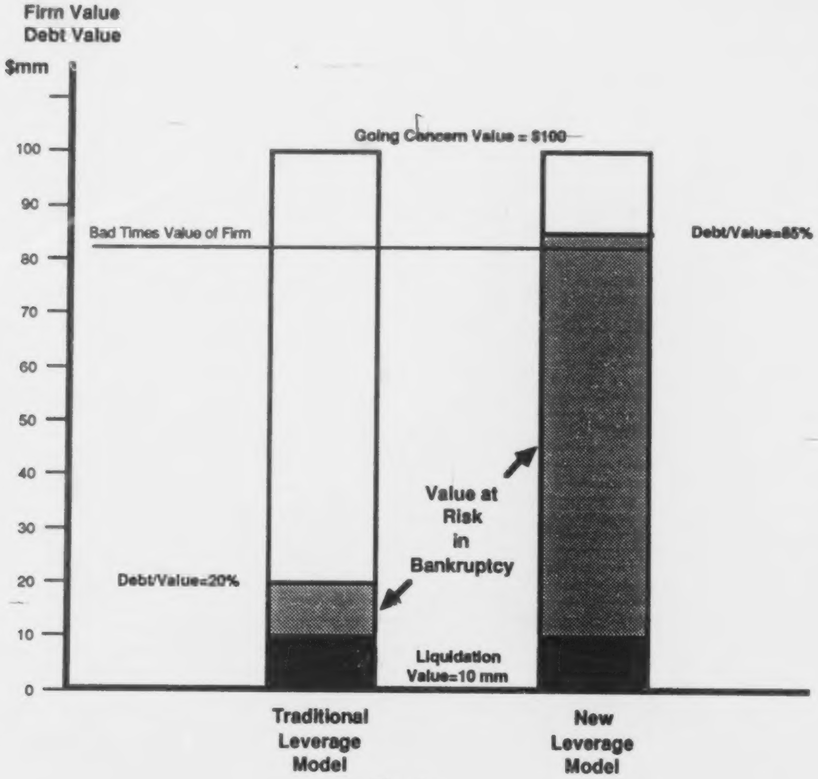

Fig. 2

This figure illustrates the relation between the insolvency point and liquidation value when the debt/value ratio is low vs high. The darkly shaded area represents the liquidation value for a given firm with assumed value of $100 million dollars. Traditionally leveraged, the firm would have about a 20% debt to value ratio (on a healthy going concern basis), while it would have about 85% debt in the new leverage model characterizing LBO and restructuring transactions. The much larger value at risk in the new leverage model if the firm should go into bankruptcy, represented by the lightly shaded area, provides larger incentives to bring about private reorganization outside of the courts.

The incentives to preserve value in the new leverage model imply that a very different set of institutional arrangements and practices will arise to substitute for the usual bankruptcy process. In effect, bankruptcy will be taken out of the courts and privatized. This institutional innovation will occur to recognize the large economic value that can be preserved by privately resolving the conflicts of interest among claimants to the firm. When the going concern value of the firm is vastly in excess of the liquidation value, it is likely to be more costly to trigger the cumbersome court-supervised bankruptcy process that diverts management time and attention away from managing the enterprise to focus on the abrogation of contracts that the bankruptcy process is set up to accomplish. These large potential losses provide incentives for the parties to accomplish reorganization of the claims more efficiently outside the courtroom. This fact is reflected in the strip financing practices commonly observed in LBOs where claimants hold approximately proportional strips of all securities and thereby reduce the conflicts of interest among classes of claimants.[9] Incentives to manage the insolvency process better are also reflected in the extremely low frequency in which these new organizations actually enter bankruptcy. The recent Revco case is both the largest such bankruptcy of an LBO and one of the handful that have occurred.

LBOs get in trouble frequently, but seldom enter formal bankruptcy. They are reorganized in a short period of time (several months is common), often under new management, and at apparently lower cost than would occur in the courts. The process has not been formally studied yet, so good empirical data is currently unavailable. Some assert that the success of LBOs has been ensured by the greatest bull market in history. The story is not that simple because during the last eight years of good times, major sectors of the economy have experienced bad times, and buyouts have occurred in many of these sectors. So although they have not been tested by a general recession, they have survived well the trials of many subsectors of the economy in the recent past. In addition, there are indications that organizations such as Drexel Burnham Lambert (which has been most active in facilitating the intensive use of debt) has anticipated these problems. They seem sensitive to the potential gains from innovation in the workout and reorganization process. Such innovation is to be expected when there are large efficiency gains to be realized from new reorganization and recontracting procedures to deal with insolvency.

There has been much concern about the ability of LBO firms to withstand sharp increases in interest rates given that the bank debt which frequently amounts to 50% of the total debt is primarily at floating rates. This problem is mitigated by the fact that most LBOs now protect themselves against sharp increases in interest rates by purchasing caps that limit any increase or by using swaps that convert the floating rate debt to fixed rates. Indeed it has become common for banks to mandate such protection for the buyout firm. These new financial techniques are another means whereby some of the risks can be hedged away in the market, and therefore the total risks to the buyout firm are less than they would have been in past years at equivalent debt levels.

It will undoubtedly take time for the institutional innovation in reorganization practices to mature and for participants in the process to understand that insolvency will be a more frequent and less costly event than it has historically been. It is reasonable to predict that this will be an area of intense future academic study.

It is possible we will discover that debt and insolvency can serve a very important control function to replace what seems to be the failed model in which the public board of directors monitors management and its strategy directly. Although I have not studied it in detail, and therefore my conclusions are tentative, the recent Revco bankruptcy seems to be an example. Revco management pursued a strategy to upgrade its drugstores to department stores. The strategy failed, but the high debt load prevented the company from pursuing the flawed project for long because insolvency and bankruptcy allowed the creditors and owners to replace managers and facilitate abandonment of the strategy. Such rapid change in management and strategy is highly unlikely to occur under the usual public director/low leverage control model of the typical American corporation.

It is interesting that the Japanese system seems to have many of the characteristics of the evolving American system. Japanese firms seem to make intensive use of leverage, and Japanese banks appear to allow a company to go into bankruptcy only when it is economic to liquidate it, that is, only when the firm is more valuable dead than alive. This appears to be the norm in the American LBO community as well. As leader of the consortium of banks lending to any firm the Japanese main bank takes responsibility for evaluating the economic viability of an insolvent firm, and for planning its recovery—including the infusion of new capital and top-level managerial manpower (often drawn from the bank itself). Other members of the lending consortium commonly follow the lead of the main bank and contribute additional funding, if required, to the reorganization effort. The main bank bonds its role by making the largest commitment of funds to the effort. Viewed in this light, the most puzzling aspect of the Revco experience is why Revco's investment bankers and creditors let the firm get into the formal bankruptcy process.

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[9] See Jensen (1988).

The Empirical Evidence on the Source of LBO Gains

The evidence on LBOs and management buyouts is growing rapidly. In general, this evidence shows that abnormal gains to stockholders are significantly positive and in the same range as gains from takeovers. Stock prices rise about 14% to 25% on the announcement of the offer,[10] and the total premium to public shareholders ranges from 40% to 56%. Kaplan (1988) shows that for those buyouts that eventually come back public or are otherwise sold, total value, adjusted for market movements, increases 109% from two months before a buyout to the final sale about 5 years after the buyout. Pre-buyout shareholders earn premiums of about 40%, and the post-buyout investors earn about 50%.[11] This 50% return is measured on the total purchase price of the pre-buyout equity and not the equity of the post-buyout firm. The median net of market return on the post-buyout equity alone is about 600%, but these returns are distorted by the fact that the equity is highly leveraged. In effect, the equity returns are almost a pure risk premium and therefore independent of the amount invested. Calculating the returns on the entire capital base used to purchase the pre-buyout equity, or the fraction of the total wealth gains that go to the pre-buyout shareholders, gives a better picture of the distribution of the total wealth created in the buyout. Average total buyout fees amount to 5.5% of equity two months prior to the buyout proposal.

Some assert that post-buyout shareholders, especially managers, earn "too much" in these transactions, and that managers are exploiting shareholders by using their inside information about the firm to buy it at below market prices. Inconsistent with this assertion is Kaplan's evidence indicating that managers holding substantial amounts of equity who are not part of the post-buyout management team are systematically selling their shares into the buyout. This is irrational behavior if the buyout is significantly underpriced in light of inside information and if such insider-non-buyout investors have the same inside information as that of the continuing management team. Moreover, they have many legal forums to press their claims because virtually all announcements of buyouts are followed by suits from the plaintiffs' bar. In addition, buyouts firm's systematically underperform the post-buyout projections they make in the proxy materials provided to selling shareholders.

If, however, the buyout gains are due to the major changes in ownership and debt that occur at the buyout and the real changes in operations they engender, there may be no alternative but to allow managers to acquire substantial equity interests. These equity interests give them the incentive to make such highly leveraged companies successful and to compensate them for the risks they are taking with their careers. One of the major risks, as Ross Johnson, CEO of RJR-Nabisco found out, is that a substantial fraction of proposed buyouts fail, and competing bids are an important reason for this failure.

Managers are subject to severe conflicts of interest in buyout transactions because they cannot simultaneously act as both buyer and agent for the seller. The system seems to work well, however, to protect shareholder interests. Directors are liable if they behave inappropriately and sacrifice shareholder interests in favor of managers, and shareholders receive protection from the fact that a bid significantly below the real value of the company (risk adjusted, of course) is likely to be met by competing outside bids. This is exactly what happened in the RJR case where the initial management bid of $75 per share was topped by two outside bidders for an eventual stated price of $109 per share, an increase of $7.7 billion. In this case the system worked well to ensure that shareholder interests were served.

Kaplan (1988) and Smith (1989) examine the operating characteristics of LBOs after the buyout and find real increases in productivity. Kaplan finds average increases in operating earnings of 42% from the year prior to the buyout to the third year after the buyout, and increases of 25% adjusted for industry and business cycle trends. He also finds 96% increases in cash flow in the same period (80% after adjustment for industry and business cycle trends). Smith also finds significant increases in operating earnings and net cash flows. She also documents improvements in profit margins, sales per employee, working capital, inventories, and receivables, and finds no evidence of delays in payments to suppliers. She finds no changes in maintenance, repairs and advertising as a fraction of sales, and no evidence that these items are being cut in ways that harm the long run health of the enterprise.

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[10] DeAngelo, DeAngelo and Rice (1984), and Lehn and Poulsen (1988)

[11] Compounding explains the remaining amount since (1.4)*(1.5)-1=110.

Corporate debt rises significantly from about 20% of assets to almost 90% after a buyout.[12] Some argue that a major part of the shareholder benefits are simply wealth transfers from bondholders who suffer when their bonds are left outstanding in the new company with its massive total debt. While it is undoubtedly true that some bondholders have lost in these transactions there is no evidence that bondholders lose on average. Convertible bond and preferred stockholders generally gain a statistically significant amount in such transactions, while straight bond holders show no significant gains or losses.[13] This result is somewhat surprising since in the majority of cases the old bonds experience significant downgradings by rating agencies. This issue has been prominent in the press as Metropolitan Life has filed suit against RJR-Nabisco for restitution of the losses it experienced on its RJR-Nabisco bond holdings. The press has greatly exaggerated the amount of the wealth loss to the RJR bondholders. The original announcement of the Johnson/Shearson Lehman offer occurred on Oct. 20. In the period September 29, 1988 to November 29, 1988 the bondholders of RJR-Nabisco suffered losses of slightly under $300 million. This loss is trivial relative to the $12.1 billion gain to RJR shareholders (calculated at the stated price of $109 per share). In any event this expropriation of wealth from bondholders is not a continuing problem because the technology to protect bondholders from losses in the event of substantial restructuring and increases in debt is available. Poison puts or other covenant provisions that require repurchase of the bonds on such events are available and can be used to eliminate such restructuring risk. One view of the RJR situation is that the Met and other bondholders gambled that no restructuring would occur in order to reap the premium they would have given up if the protection had been included in the bonds they bought in 1988. Having gambled and lost they are now asking for compensation.

The effects of LBOs on labor have not been thoroughly studied to date, but evidence in the Kaplan study indicates that median employment increases by 5.9% after a buyout, (-5.4% after adjustment for industry conditions).[14] Thus, although employment does not systematically fall after a buyout, as yet no data has been found that allows inference on whether wages are cut after a buyout. There is also concern about the effect of LBOs on R&D expenditures. This concern seems unwarranted because the low-growth old-line firms that make good candidates for highly leveraged LBOs don't invest in R&D. Kaplan and Smith (1989) respectively each found only seven firms in their respective samples of 76 and 58 firms that engaged in enough R&D to report it in their financial statements.

Another area of controversy is the amount of value transferred from the U.S. Treasury in the form of tax subsidies to buyout transactions. The argument is that the massive increases in tax deductible interest payments virtually eliminate tax obligations for buyout firms. In the year following the buyout, Kaplan finds that 50% of the firms pay no taxes. However, because of operating improvements and the retirement of some debt, average tax payments are essentially back to the pre-buyout level by the third year after the buyout. Moreover, these subsidy arguments ignore the large increases in tax payments generated by the buyout in the form of capital gains tax payments by pre-buyout shareholders who are forced to realize all the gains in their holdings, the tax payments on the large increases in operating earnings caused by the buyout, and the tax payments by the buyout firm creditors who receive the interest payments. Direct estimates of the total effect on Treasury tax revenues taking account of all such gains and losses indicate the present value of revenues increases by about $110 million under the 1986 tax rules on the average buyout with a price of $500 million. Converted to an equivalent annual increase of $11 million, these revenues are an approximate annual increase of 61% over the average $18 million tax payment by buyout firms in the year prior to the buyout. On a current account basis, that is, considering only the tax effects in the year after the buyout, the Treasury gains $41 million over the average pre-buyout tax payments.[15] Conservative estimates indicate that at worst the Treasury is unlikely to be a net loser from these transactions. If the value increases are the result of real productivity changes, rather than merely transfers of wealth from other parties, then it is not surprising that the

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[12] Kaplan (1988), see also Marais, Schipper and Smith (forthcoming).

[13] See Marais, Schipper and Smith (forthcoming).

[14] For companies without significant divestitures in the post-buyout period.

[15] Jensen, Kaplan, and Stiglin (1989)

Treasury is a winner. In the controversial RJR-Nabisco case the $12 billion plus gains are likely to generate net incremental tax revenues to the treasury totalling $3.8 billion in present value, and about $3.3 billion solely in the year following the buyout.

Conclusion

LBOs are an interesting example of control transfers that highlight the effect of changes in organizational form and incentives on productivity. It appears there is no explanation for most of the gains other than real increases in operating efficiencies. That in itself is interesting because these are generally situations in which the same managers with the same assets are able, when faced with better incentives, to double the productivity and value of the enterprise. It is also surprising that it is so difficult to find losers in these transactions. Some middle and upper managers lose their jobs as the inefficient and bloated corporate staffs are replaced by LBO partnership headquarters units who rely on incentives (created by equity ownership, performance sensitive compensation, and high debt obligations) and decentralized decision making as substitutes for direct involvement by corporate headquarters in decision making.

As major innovations in corporate organization continue mistakes will occur. This is natural and not counterproductive. How can we learn without pushing new policies to the margin? The surprising thing to me is that there have been so few major mistakes or problems in a revolution in business practice as large as that occurring over the last decade. Many of the proposed changes in public policy toward these transactions threaten to stifle this re-creation of the competitiveness of the American corporation. Perhaps the most dangerous of these policy proposals are those to limit the formation of debt and the distribution of resources from corporations by imposing various tax penalties.[16] Removal of biases towards higher debt in the tax system would be desirable, but not if the proposed solutions created large inefficiencies as they threaten to do.

The best and simplest way to remove any counter-productive tax-induced bias toward debt is to eliminate the double taxation of dividends by making them tax deductible at the corporate level. This change would generate large additional efficiency gains in the economy because it would reduce the incentives for corporations to retain substantial amounts of funds even when they have no profitable projects in which to invest them. This change would eliminate some of the most inefficient acquisitions that take place. These acquisitions are frequently engineered by managers flooded with free cash flow they are unable to invest in the businesses they understand but are reluctant to pay out to shareholders for reinvestment elsewhere in the economy. Some of the best examples of this have occurred in the oil, tire and tobacco industries — all industries that have been forced to shrink their operations in the last decade. As in the past, elimination of double taxation of dividends is likely to be opposed by corporate managers who wish to avoid pressure for increased payouts to shareholders. Reforming the bankruptcy process to limit the courts' abrogation of contractual priority of claims voluntarily agreed to by security holders is also an important function that policymakers should address.

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[16] Perhaps the most extreme example is American Law Institute (1988), which proposes a minimum tax on corporate distributions as an alternative way to accomplish "debt disqualification." This proposal would exacerbate the major free cash flow problem facing the American corporate sector (see Jensen (1986, 1988) by locking into place penalties for the distributions that must occur to resolve the problem.

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STATEMENT OF ALAN J. AUERBACH, PH.D., PROFESSOR AND CHAIRMAN, DEPARTMENT OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA

Mr. **Auerbach**. Thank you very much, Mr. Chairman. I will simply make a few points in summarizing my written testimony. I would be happy to answer questions afterward.

I come to a number of conclusions in my testimony. First of all, it is certainly true that corporate debt-equity ratios have risen a lot in recent years in the United States. The conclusion that one reaches here depends on how one measures debt-equity ratios, but however one measures the current levels of debt in the corporate sector are not unprecedented for the United States over the postwar period.

We have experienced these levels in the aggregate before, and, indeed, they are not yet as high as those observed in many of our trading partners, most notably Japan, but also countries in Western Europe.

So certainly the level of debt itself, without other considerations, is not something that should be an object of serious concern. On the other hand, one certainly might look at recent increases in borrowing and recent levels of share repurchases largely associated with cash-financed acquisitions and leveraged buyouts and ask what is driving it and whether it is going to continue.

Certainly if the trend in the last few years were to continue at the same rate, then several years from now the levels of debt would be unprecedented for the United States and would be something that we ought to be thinking about.

And what we should think about is the extent to which these increases in borrowing in recent years have been driven by the Tax Code. My own personal view is that perhaps the most important thing that has driven borrowing in recent years has been the fact that we haven't had a recession since 1982. Borrowing picked up as we came out of the recession in the early eighties and it has been getting stronger and stronger since then. It may just be that the more stable growth of the economy in the last several years has made persons perceive, whether correctly or not, that the future will bring more of the same, that it is safer to incur higher levels of debt than it might have been in 1982.

Borrowing is favored relative to issuing stock, but these provisions have been in the Tax Code for a long time. They certainly predated the current wave of LBO's. In fact, the evidence is quite clear that, overall, the Tax Code favors borrowing less now than it did before 1986 because, although there has been a reduction in individual rates and reductions in the rates of tax that investors pay when they receive interest—which makes debt financing more attractive—there has also been a considerable reduction in the rate at which those interest payments can be deducted by corporations.

While, for some investors, the reduction in individual taxes might seem to outweigh the reduction in the corporate rate, for other types of investors, notably pension funds and other tax-exempt investors, the reduction in the corporate rate is really all that matters. For them equity looks relatively more attractive than it did before.

If one combines that with the fact that there are additional provisions that impinge particularly on transactions meant to replace equity with debt, rather than simply creation of new debt or creation of new equity, then the conclusion is even stronger. I have in mind first the increase in capital gains tax rates in 1986. These tax rates apply whenever there is a transaction to repurchase shares. The capital gains taxes that are paid are higher now than they were before.

In addition, provisions that apply when there are mergers and acquisitions, for example, repeal of the *General Utilities* doctrine in 1986, also make these transactions less advantageous from the tax point of view.

I don't believe that anything that Congress has done actively in the tax area has encouraged the recent growth of merger activity.

Now one could still argue logically that taxes are driving, or at least are in part behind the transactions. It may be the case, for example, that other factors such as the increase in competitiveness in the market for corporate control and the reduced cost of financial intermediation—making it easier for large pools of money to be made available to people who want to engage in transactions—have reduced the cost of engaging in these transactions, that the tax advantage, which was always there, may not be even as large as it once was, but is still large enough, when combined with other factors, to get people to engage in these transactions.

This brings me to my suggestion of what the policy objectives should be in this area. It seems as though there is still a tax advantage to borrowing. It really is hard to say to what extent this tax advantage lies behind the recent levels of activity. Perhaps the policy that one should adopt, given this uncertainty, is to do what appears to have been the right thing all along, to try to equalize the tax treatment of debt and equity and ensure that that factor is not lying behind the level of leveraged buyouts and other sorts of related deals that are occurring right now.

Given the increasing difficulty even of telling debt from equity, the direction that should be taken is not one of trying to choose particular kinds of debt to single out for tougher treatment, either in terms of what the money is used for when borrowing is done or in terms of the interest rate being paid on the debt, because identifying particular kinds of debt that fall into a category or don't fall into a category are becoming difficult.

There is a logical problem, given the fungibility of money, in saying, well, this debt is bad, this debt is good, and so forth. It makes more sense to look broadly at the tax treatment of debt and equity, and there, there is some combination of decreasing the attractiveness of debt and increasing the attractiveness of equity that would be appropriate.

I don't think there are any simple answers. The Treasury's past estimates of what it would cost to institute, for example, a dividends paid deduction suggest that the number would be far larger than could be seriously considered at this time unless other measures were considered at the same time. In that regard, a variety of schemes that would move toward a more level treatment of debt and equity without losing so much revenue would be, perhaps, preferable to doing nothing at all.

Beyond that kind of change in the overall tax treatment of debt and equity it is not clear that other items would be appropriate.

Thank you, Mr. Chairman.

[The statement of Mr. Auerbach follows:]

STATEMENT OF ALAN J. AUERBACH, PROFESSOR AND CHAIRMAN, DEPARTMENT OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA

Mr. Chairman and Members of the Committee:

The recent explosion in corporate borrowing and leveraged buyout activity raises significant questions about tax policy and financial regulation. This committee is to be commended for addressing these questions so swiftly. I will begin my testimony by stating my conclusions.

1. Corporate debt-equity ratios have risen sharply in recent years. This increase is largely attributable to increases in share repurchases, cash-financed acquisitions and leveraged buyouts. Yet current debt-equity ratios are not unprecedented for the United States, nor do they yet compare to those observed in Japan or in many other industrial countries.

2. The increase in borrowing and merger activity cannot be attributed to changes in tax provisions. While certain incentives to borrow and acquire are provided by the Internal Revenue Code, these have existed for many years and, in some cases, were actually reduced by the Tax Reform Act of 1986.

3. The ultimate aim of tax policy should not be to discourage borrowing in general or leveraged buyouts in particular, but simply to ensure that such activities are not driven by tax advantages.

4. Given the increasing difficulty of telling debt from equity, the only practical way to achieve "neutrality" is to reduce and eventually remove the distinction between debt and equity imposed by the income tax. A component of most plans would be tax relief for corporate dividends, but the relief must be restricted in some way to avoid enormous losses of tax revenue.

DEBT-EQUITY RATIOS

There is little question that fundamental changes in corporate financial behavior have occurred in recent years. In every year since 1984, net corporate equity issues have been negative. After appearing to level off at an annual level of about $80 billion through 1987, net repurchases occurred at an annual rate of $109 billion during the first three quarters of 1988, according to statistics compiled by the Federal Reserve Board. The bulk of this decline in equity is attributable to cash-financed acquisitions, although share repurchases have also played an important role.

Over this same period, corporate borrowing has increased. Net annual borrowing by nonfinancial corporations averaged $64 billion during the period 1980-83, $153 billion during the period 1984-87, and $183 billion during the first three quarters of 1988.

Despite this evident shift away from equity and toward debt, the aggregate corporate debt-equity ratio is still not especially high by historical standards or by international comparison. At the end of 1987, the debt-equity ratio of the U.S. nonfinancial corporate sector, measured at market values, was .71. This ratio has hovered between .62 and .76 since 1980, and indeed was higher during the entire period from 1974 to 1979. Measured at book values, the current aggregate debt-equity ratio is higher than during the last decade, but comparable to those of the late 1960s and early 1970s. By comparison, the aggregate debt-equity ratio for Japanese nonfinancial corporations has exceeded 1.0 (more debt than equity) for decades.

These aggregate statistics suggest that current levels of indebtedness of U.S. corporations are not dangerously high. What is cause for concern, though, is the speed with which debt has recently replaced equity and the prospect that the shift may continue at this pace. At some point, the financial stability of U.S. business could become a serious issue. While I cannot offer a definitive explanation for recent behavior, I do not believe that changes in tax policy are the cause.

BORROWING AND THE CORPORATE TAX

Corporations deduct their interest payments in computing their taxable income, but cannot deduct dividends. Because of this, companies are encouraged to finance their investments by borrowing rather than by issuing new equity. This is a defect of the system of taxation under which we treat corporations as separate entities, but it has always been one. Little has happened in the relative treatment of debt and equity that can explain recent changes in financial behavior.

The Tax Reform Act of 1986 reduced the corporate tax rate from 46 percent to 34 percent, cutting by over one-fourth the value of the corporate interest deduction. This can hardly explain an increase in borrowing. One must look at the taxes paid by asset holders to get a complete picture of the total tax burden. Marginal tax rates on interest receipts and dividends also fell under the 1986 Act, especially for high income investors. On the other hand, capital gains tax rates rose. Since a significant part of the return to equity is typically in the form of capital gains, the net impact of these provisions was to lower the individual tax burden on interest income by considerably more than on total returns to equity. This works against the reduction in the corporate tax rate, and the net impact depends on an investor's tax bracket. Among high bracket investors, for whom the reduced tax burden on interest payments is significant, the net result has been to encourage corporate borrowing. For another significant class of investors, tax exempt institutions and pension funds, only the corporate tax changes are relevant, and these discourage the use of debt. If one weighs the effects on different classes of investors, the 1986 Act appears, on balance, to have discouraged borrowing.

A second factor discouraging the use of debt recently has been the decline in the rate of inflation and nominal interest rates. Since the potential tax advantage of borrowing is attributable to the deductibility of nominal interest payments, this decline in interest rates would have reduced the tax advantage of borrowing even had there been no change in marginal tax rates.

As recent changes in tax rules and inflation have discouraged borrowing in general, they have put an even greater damper on borrowing associated with cash acquisitions and leveraged buyouts. I have already described the changes in the relative tax burdens on returns to equity and debt. But to convert equity to debt, corporations and shareholders must bear additional taxes. The increase in capital gains taxes hits equity repurchase transactions with full force, to the extent that shareholders are taxable. This is especially true in the case of acquisitions, because the premia associated with tender offers are fully taxable at the capital gains tax rate. Moreover, the 1986 repeal of the General Utilities doctrine means that the tax benefits of stepping up asset bases are likely to be more than offset by immediate corporate capital gains tax liabilities. On balance, it is very difficult to argue that debt-financed takeovers have been newly encouraged by the tax system. The evidence is very much to the contrary.

Why the increase in borrowing and debt-financed takeovers? I believe there are several causes. One is the macroeconomic performance of the 1980s. The U.S. economy has been growing steadily since 1982. The fear of financial reverses that normally limits borrowing may well have subsided as memory of the last recession faded. Another important factor is the changing nature of U.S. financial markets. The increasing availability of large pools of funds to finance potentially risky borrowing on a significant scale has helped. There has been considerable debate over the social value of "junk" bonds and whether markets have adequately measured the risk they carry. But, in general, innovations that reduce the cost of financial intermediation and make funds more available are technological advances just as much as discoveries that reduce the costs of manufacturing processes. Historically, the development of financial intermediaries has played a significant role in the rise of industrial economies. We hardly should lament the continuation of this process or the changes in financial structure that it brings.

Borrowing has also increased, I believe, because of an increase in the competitiveness of the market for corporate control. Whether involved in a takeover or not, managers are being pushed to borrow more to maintain equity values. In this more competitive market for corporate control, fostered by relaxed antitrust enforcement and the increasing availability of funds, corporations have often been driven to borrow as a way to increase the value of their shares and thereby defend against potential acquisition. Directly or indirectly, the takeover process has spurred corporate borrowing and its associated increases in share values.

Not all of this increase in value has been socially beneficial. Increased borrowing can reduce the value of existing corporate debt, in effect transferring resources to shareholders from the owners of outstanding debt. Another source of value that is equally unproductive from the social perspective is the reduction in federal tax burden associated with borrowed funds. Even though the tax incentive to borrow has not increased, the pressure to take advantage of this tax incentive has. While perhaps helping shareholders, competition that forces corporations to reduce their tax burden is hardly in the public interest. Evidence on leveraged buyouts from the period through 1986 suggests that a substantial part of the takeover premium can be explained by tax factors. However, such evidence also suggests that companies taken private subsequently reduced operating costs, a result some would attribute to the increased pressure of having to meet higher interest payments. Even though the revenue loss should not be ignored, the continued growth of LBO activity after 1986 suggests that nontax factors play an important role.

In summary, the tax incentive to borrow has not increased in recent years, though pressure on managers to take full advantage of this incentive may help explain increased corporate borrowing. At the same time, the strong economy, the reduced cost of financial intermediation and increased pressure on managers to operate efficiently may also have played a significant role in encouraging corporate borrowing.

THE SOCIAL COSTS OF BORROWING

There is little question that tax-driven borrowing is an appropriate target of tax reform. If borrowing has tax advantages, then those who borrow impose a cost on the rest of society by increasing the amount of tax that must be raised from other sources. Some would argue that corporate borrowing, even if not tax driven, has social costs beyond those recognized by those who borrow, that a "level playing field" is still too generous to borrowing. I do not subscribe to this position, but believe the arguments are worth review.

Restrictions on Monetary Policy

If a significant fraction of the corporate sector is deeply in debt, a credit crunch with sharply rising interest rates would drive many firms into bankruptcy. The prospect of such a debacle might impede the ability of the Federal Reserve to use tight monetary policy to fight inflation. Hence, more borrowing might inevitably lead to more inflation.

This theoretical possibility is not very convincing, particularly given the behavior of monetary policy in recent years. In the early 1980s, the economy experienced the deepest recession since the Great Depression, as a tight monetary policy was successfully used to bring the inflation rate down rapidly. If the Fed is willing to fight inflation with unemployment rates exceeding 10 percent, why should it be cowed by higher rates of default?

Lack of Long-Range Planning

Managers of U.S. firms have been criticized for being too concerned with short-run results, and have been compared unfavorably to their foreign counterparts, notably the Japanese, in this respect. The increased pressure to meet interest payments is viewed by some as increasing the pressure to focus exclusively on short-run results.

There are several difficulties with this line of argument. Perhaps most obvious is that, as I have already pointed out, Japanese firms have significantly higher debt-equity ratios than do those in the United States. Moreover, companies taken private typically have been mature companies in stable industries with little research and development or long-term spending. There is no evidence to support the related argument that firms involved in ordinary mergers and acquisitions experience a reduction in expenditures on research and development.

Reduced National Saving

There is little doubt or disagreement that the U.S. saving rate is very low, particularly in light of the federal budget deficit. In recent years, private saving has barely exceeded public dissaving. Corporate saving, via retained earnings, typically has accounted for about half of all private saving in the United States. By substituting debt for equity, corporations are committing themselves to save less. Some fear this will reduce private saving as a whole.

Although this is a worrysome prospect, there is no evidence that increasing distributions of funds from corporations, either through interest payments or increased dividend yields, in itself causes a decline in the level of private saving. The recipients of these funds are not prohibited from reinvesting them. My own recent research on this subject fails to turn up any evidence that changes in corporate financial policy, by themselves, affect the rate of private saving.

THE APPROPRIATE OBJECTIVES OF TAX POLICY

The main problem associated with corporate borrowing - if any problem exists - is the tax advantage of borrowing that remains even after the Tax Reform Act of 1986. Once this advantage is eliminated, no further restrictions on borrowing are necessary. Even if the tax advantage is not eliminated, the imposition of borrowing restrictions represents a poor substitute for the direct solution.

Borrowing Restrictions

Several restrictions have been proposed to limit corporate borrowing. The simplest would be to reduce the deductibility of interest payments on all corporate debt. This is the most general type of borrowing restriction and for many reasons the most attractive. It is the simplest to enforce, for it is easier (though not necessarily easy) to identify debt than to identify debt incurred for particular reasons. Reducing interest deductibility also attacks the underlying problem, which is the tax advantage of debt over equity. Finally, it can be implemented to satisfy other objectives as well, such as raising tax revenue and moving toward a system of taxing real income, with only the real component of interest expense (and not the inflation premium as well) deductible. The main drawback of reducing the deductibility of interest is that it exacerbates the distinction between corporate and noncorporate investment; the latter already enjoys a lower overall rate of tax. It would be better to achieve neutral tax treatment of debt and equity by lowering the tax rate on equity income, for this would also reduce the distortion between corporate and noncorporate investment.

Other, narrower restrictions on borrowing are far less attractive, being harder to implement and more difficult to justify. One type of policy that has been considered seriously in the past would limit the deduction of interest on debt incurred to finance takeovers. Like other targeted borrowing restrictions that have been introduced in recent years, such a restriction would introduce great complexity to the tax system. Identifying such debt would be very difficult, for money is fungible. Even if this problem were overcome, I can see no reason to discourage takeovers this way;, what problem is such a measure supposed to address?

Another restriction on borrowing would place a cap on interest deductions based on some relatively safe rate of interest, making the excess interest on high-yield, lower grade bonds nondeductible. Once again, I see both administrative and logical problems with such a policy. From the administrative viewpoint, one would have to identify the interest rate on each obligation. How would one treat bonds that had been downgraded after their issue, for example? One might seek to rationalize this policy by pointing to the fact that it removes the tax advantage of borrowing once there is substantial risk of default. However, the extent to which interest deductions should be denied to produce neutrality between debt and equity depends on the relative tax treatment of debt and equity, not on the riskiness of the debt. An alternative argument is that once debt becomes risky, it is like equity and should be treated like equity. But the sources of risk for equity and low grade debt are quite different.

Equity Relief

As I have already suggested, the best approach to the unequal taxation of debt and equity is to reduce the tax burden on corporate equity. A simple and straightforward approach, already practiced in many countries, is some form of "dividend relief," implemented either through a deduction for dividends paid (also called a split-rate system) or through a shareholder credit (also called an imputation system). The problem with such a plan is also simple: it is very expensive. The Treasury's November 1984 tax reform proposals included partial dividend relief in the form of a 50 percent deduction for dividends paid. It was then estimated that this plan would cost the Treasury $30.9 billion in fiscal year 1990. Little has happened since that would alter this estimate substantially. Such partial dividend relief, and certainly more complete relief, is entirely impractical at present. Even a 10 percent dividends paid deduction would cost roughly $6.7 billion during fiscal year 1990, according to the estimates presented in the president's 1985 tax reform proposals.

These proposals are expensive because they would create windfalls. Most dividends paid during the next few years will come from income on assets already in place. Reducing the taxes on all such income is a very inefficient and (to the recipients of such income) overly generous method of correcting the distortion between debt and equity finance. There are many ways to make this policy more efficient, but each has its drawbacks.

1. A tax on windfalls

Institute the policy, but combine it with a tax on the windfalls generated. The most straightforward approach would combine a dividends paid deduction with an offsetting tax on some measure of current dividend capacity, such as accumulated earnings and profits. For example, a 50 percent dividends paid deduction would be combined with a 17 percent (50 percent of the 34 percent corporate tax rate) tax on accumulated earnings and profits. The windfall tax could be made payable over several years. The logic of this policy is that it would eliminate the net benefit of the deduction for all dividends paid out of past earnings and profits; it would provide a net reduction only for dividends generated by new equity capital. Depending on the timing of the windfall tax, the total package could raise revenue for a number of years. The disadvantage of this policy is not economic but political. The president's 1985 proposals included a similar provision (to reduce the windfalls arising from the corporate rate reduction) that proved to be extremely unpopular, and I am sure this policy would have a similar reception. That is unfortunate, because from an economic perspective it is clearly the best policy.

2. The ALI proposal

Institute the policy of dividend relief only for new equity issues, and combine this with restrictions on the conversion of existing equity to debt or new equity. This is the proposal circulated by the American Law Institute (ALI). The most recent version (dated November 1988) would provide a dividends paid deduction based on the extent of new equity contributions, and would at the same time impose an alternative minimum tax of 28 percent on nondividend corporate distributions, withheld at the corporate level and credited against shareholder tax liability on the distributions.

The ALI proposal is intended to limit windfalls by excluding existing equity from dividend relief. Under certain assumptions, this approach would provide the same incentives as the combination of full dividend relief and a windfalls tax. Neither the tax on accumulated earnings and profits nor the ALI proposal would either discourage or encourage conversions of existing equity into debt. This would be true in spite of the new tax on nondividend distributions because this tax (or the ordinary tax on dividends) would apply to any distributions a corporation made in the future. Thus, the tax could be deferred (with interest, since distributions would be greater in the future) but not reduced in value, and so, like the tax on accumulated earnings and profits, could not be avoided.

The ALI plan is a more elaborate way of achieving the tax on windfalls. In effect, the corporation rather than the government decides when the tax is paid; the unpaid balance accumulates interest. The proposal's major "benefit" is that it is less clearly an unavoidable capital levy. While this lack of transparency may make it more acceptable, it also makes it harder to understand and, I would presume, enforce. This is evident from the many drafts through which the proposal has gone. Unlike the more straightforward policy, its effectiveness depends on taxpayers believing that its provisions are permanent. A permanent tax on distributions may not affect the timing of such distributions, but a temporary tax would. Given the frequency with which tax provisions change, any tax on distributions may be perceived as a temporary one. In this case, the ALI plan would strongly discourage share repurchases, leveraged buyouts and other cash acquisitions. It might even discourage dividends, if corporations anticipated that dividend relief would be made available to all dividends in the future.

My conclusion is that the ALI plan's chief distinction is that it is more difficult to comprehend than a windfalls tax. At best, its impact would be identical, but it might very well impose costly distortions as the price for its complexity.

3. A hybrid approach

Combine a partial dividends paid deduction with a partial denial of the deduction of interest. Although this approach would raise the overall burden on new corporate investment more than either of the previous approaches (it pays for dividend relief with an increase in the tax burden on debt-financed corporate investment), it would still achieve neutrality between corporate debt and equity without a significant revenue cost. It is a workable approach that does not depend on novel tax instruments or particular expectations about future policy, but it also imposes costs (in discouraging corporate investment) that may outweigh its benefits (removing the distortion of corporate financial decisions).

4. Capital gains taxes

Although I have focused primarily on the relative tax treatment of dividends and interest, the taxation of capital gains also exerts an important influence on corporate financial decisions. Like reductions in the tax burden on dividends, capital gains tax cuts, in the long run, will reduce the tax incentive for corporate borrowing. In the short run, however, they will also reduce the tax cost of converting equity into debt, by lowering the tax burden on shares redeemed by corporations. By the same mechanism that the

ALI plan, with its increased tax on redemptions, could discourage takeovers and conversions of equity into debt, a capital gains tax cut could encourage them.

There are many other questions that should be addressed in deciding whether and how to change the way capital gains are taxed. One should not view a capital gains tax cut as a way to reduce conversions of equity into debt.

CONCLUSIONS

In a dynamic economy experiencing financial innovations and more competition for corporate control, it is natural to ask to what extent the changes we observe are for the best. It is not clear that the tax advantage to debt is an important cause of recent increases in borrowing, but this distortion has merited correction for many years and might well be addressed now to ensure that it play no part in influencing future behavior. The solution chosen, however, ought to satisfy the ultimate objectives of taxation rather than simply assuage the fears of the moment.

Chairman ROSTENKOWSKI. Thank you, Mr. Auerbach. Mr. Ribstein.

STATEMENT OF LARRY E. RIBSTEIN, PROFESSOR OF LAW, GEORGE MASON UNIVERSITY, ARLINGTON, VA

Mr. RIBSTEIN. Thank you, Mr. Chairman. I appreciate the invitation to appear before you this afternoon. I want to make a few simple points. My cohorts on the panel have made a lot of the points that I think are relevant.

The first point is I think there is a feeling around that a AAA debt rating is a good thing, and that as you decline in the bond rating you get closer to being bad. I think that that is simply a mistake. When you move from a low debt equity ratio to a high debt equity ratio, you are simply moving from one form of contract to another within the corporation. And for many corporations, the contract that you get with the high debt equity ratio may well be better. Mr. Jensen gave us some figures that I think back that up to some extent.

What you are doing is replacing some very general duties of directors and some very general kinds of discipline, market for control, fiduciary duties and so forth, with a more specific kind of discipline in terms of the duty to pay interest, make principal payments and so forth. Sometimes the general control that you get in a dispersed shareholder, high bond rating kind of company is simply not the most productive kind of contract. To some extent, for instance, subjecting the directors to fiduciary duties is becoming a little bit like what one pundit once called dog law. In other words, you know when you have done wrong when you get bit. To some extent that is not necessarily an efficient contract to run a company under.

I think that explanation about why this is a better contract backs up some of those figures we heard from Professor Jensen about the increase in earnings and so forth that we observe in post-LBO companies. What we are looking at is an increase in productivity. Somebody mentioned earlier today, what are we going to do about the trade deficit? One way to get the trade deficit down is to increase the productivity of American business, and there is substantial evidence that LBO's can do that.

Now I want to respond to some problems that have been raised about LBO's and very briefly talk about why I think they are not as serious as has been contended. For one thing, it has been said that LBO's increase the possibility of collapse. That these companies are brought to the brink of collapse by a high debt-equity ratio.

I think that is based on a mistaken view that just because the equity cushion or the coverage ratio has gotten closer to the edge that that company is necessarily weaker. But if you buy, as I do and as I think the figures support, the idea that LBO's can make a company more productive, then you are talking about two kinds of changes. Of course, you are lowering the equity cushion, but you are also making it a more successful company in general.

There was a reference earlier today to Phillips Petroleum, and I noticed in the Wall Street Journal article that one of the things that had happened to Phillips as a result of having been threatened by takeovers is that they had cut their costs. This is one thing that LBO's definitely do. What happened to Phillips was that that made their profits more sensitive to upturns in their business. In other words, they were able, according to the Wall Street Journal article, to greatly increase their productivity because of an upturn in business. I think also that kind of thing will make companies less sensitive to a downturn. If they have decreased their costs, there is going to be less of a chance that they are going to collapse.

Another point I want to make is that when a company fails to make its interest payments it does not disappear into a black hole. There is then simply an occasion for renegotiation, and restructuring of the contract. The company will continue if it is worth more as a going concern unless—and this is a big caveat I want to make—unless bankruptcy costs make that difficult. I want to echo what Mr. Jensen said, that maybe one thing we ought to look at is changing the bankruptcy system to make that less costly rather than cutting down on what I think can be an efficient form of contract.

Second, it has been said that LBO's hurt existing creditors. As Professor Jensen said, there is a lot of evidence that that is not true. But I also want to point out, as he did, that even if it were true, that some creditors were getting caught in the middle of these deals, they did make bargains and we have a very substantial law of contracts that protects them. I want to add the fact that we also have a very substantial law of fraudulent conveyances and fiduciary duties that protects these creditors, and I do not think there is any need for any additional action by this or any other committee.

It has also been said that LBO's put employees out of work. Again, we have all kinds of evidence that LBO's, in fact, make companies more productive. But I do not want to deny completely that one of the effects of focusing managers on the bottom line is that sometimes that will lead to layoffs.

What do you want to do about it? It seems to me that the wrong way to go is to keep managers' attention off the bottom line. Managers are not necessarily the ones who are going to look out for the employees. In the RJR Nabisco case it was KKR, the winning deal, that was thinking more about the employees than the original management group that tried to take over the company.

So you do not help the employees by taking managers' attention off the bottom line. If you want to help the employees, to keep them from getting fired and so forth, then consider that specific kind of approach rather than just helping managers.

Another point I want to make, and it has been pointed out in these hearings and also in the Senate hearings, is that there is a difference between LBO-type transactions and corporate consolidations. In corporate consolidation, employees often get laid off eliminating redundant jobs. What LBO's do in general is keep managers' attention on the bottom line, and keep them from doing inefficient consolidations.

I think when you add that fact with the increase in productivity that we have seen in LBO's, the best way to hurt the employees of this country is to legislate against LBO's. LBO's are helping employees a whole lot more than they are hurting them. There was an example of that in the Senate hearings. When Duracell was freed from Kraft, its productivity went up and it hired more employees. You had an improvement in the contract in the sense that division managers did not have to submit to interference from central management and so forth.

Does that mean that everything is perfect and nothing should be changed? The answer is no. I do not want to go on record as saying that there are no LBO's that have been caused by tax incentives, by tax breaks that companies get from the deductibility of interest and so forth. I agree with what many witnesses have said, that what this committee needs to do is move towards tax neutrality which is, do not treat different forms of governance contracts differently in terms of taxation.

What you see is a whole range of contractual terms. If you push one place, problems are going to pop up somewhere else. For instance, you got rid of the so-called break or loophole of publicly traded limited partnerships. Fewer companies are doing that, but it is quite possible that companies that would have become publicly traded limited partnerships are now seeking the other way out of the corporate tax, which is leveraged buyouts.

So what you do? Do you decrease the deductibility of interest? That simply increases the incentives to move toward non-corporate forms of business. You are making it less advantageous to be a corporation.

The only way to avoid this business of pushing one place and having problems pop up in another place, by eliminating the double level of taxation and moving more toward neutrality. You can talk about the revenue implications of that, but I think it is important to separate two points. One, how you tax business, how you tax income coming into the corporation. And secondly, the rate that you tax it at.

What I am saying is, if the way that you tax corporate income is by having all these perverse incentives to do business in a particular way just to avoid the tax man, you are causing more problems than you are solving.

Thank you, Mr. Chairman.

[The statement of Mr. Ribstein follows:]

STATEMENT OF LARRY E. RIBSTEIN, PROFESSOR OF LAW, GEORGE MASON UNIVERSITY

I. Introduction

Popular concern about leveraged buyouts and increased corporate debt is misplaced. Both takeovers and corporate debt play a positive role within the complex web of contracts that forms the modern corporation. Moreover, these contracts and the efficient securities markets ensure that changes in the corporation improve efficiency rather than merely shift wealth between groups.

If there is a problem in corporate governance that should be addressed by changes in the tax code, it is that tax law discriminates against both the corporate form and equity investments in corporations. This discrimination, by encouraging inefficient capital structures and transactions, reduces productivity. The solution to this problem is tax neutrality, which cannot be achieved by further use of tax benefits and penalties to manipulate governance contracts.

II. Debt and the Corporate Contract

A. The Positive Role of Debt

Debt is fundamentally nothing more than a very general type of contract among those who provide capital to a firm. Before enacting tax provisions penalizing debt, it is vital to understand the functions served by this type of contract.

In the public corporation, debt can be viewed as one of several ways of reducing problems arising from placing management powers in corporate executives and directors subject only to control by the shareholders. Where the shareholders each hold only a relatively small percentage of the stock, it will rarely be in the interest of a single shareholder to expend the resources necessary to do something about poor management. Most shareholders simply toss their proxy materials in the ashcan despite the best efforts of the proxy rules to make them responsible corporate "citizens." The result is what seems to be a "separation of ownership and control," as Berle and Means contended over 50 years ago.[1]

Incentive compensation, markets for managerial services, outside directors and auditors and other devices serve to control management discretion. But there must be some way to ensure that these devices and markets are adopted and work effectively. That "super-monitor" is the "market for corporate control." The mechanism that drives this market is the efficient securities market, which ensures that information about a company is efficiently reflected in the price of the company's stock. If management has either acted selfishly or has simply failed to make a change in operations or to seize a business opportunity, an outsider can make a profit by buying control, making the appropriate change, and reaping a profit when the stock price rises to reflect the change.

But the market for control and other incentive and monitoring devices do not perfectly align management and shareholder interests. Any potential improvement to the corporation from a change in management through the market for control would have to be significant in order to justify paying the increasingly large premium required to buy control. This leaves a margin for management inefficiency. To take up some of this "slack," the corporate contract provides for general judicially enforced fiduciary duties.

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[1] Adolph Berle & Gardiner Means, The Modern Corporation and Private Property (1932).

The combination of incentive and monitoring devices, the market for control, and fiduciary duties may work reasonably well for many publicly held corporations. But there are serious costs to this system.

First, the incentive effects of the market for control are not costless. Even managers who are maximizing shareholder value have reason to be concerned that someone else will come along with a better idea. The risk of takeovers forces managers to keep an eye open for their next job rather than fully committing their efforts to their current job. Moreover, publicly held corporations, which compete in the employment market with other types of firms, will have to pay top managers to bear the cost of job insecurity.

Second, fiduciary duties are vague and costly to enforce and place managers at risk of being held liable even for good faith business judgments. For example, the Delaware Supreme Court, in Smith v. Van Gorkum,[2] held managers liable for approving a leveraged buyout without obtaining sufficient information about the value of the company. The case sent shock waves through the business community, reminding managers how vulnerable they were to judicial second-guessing at the behest of shareholders. One result was numerous statutes changing, or permitting the shareholders to change, the directors' standard of care.[3]

Finally, even with all of these costs of the control market and fiduciary duties, shareholders are still exposed to some risk that managers will pursue their own rather than the shareholders' interests.

It is not surprising, therefore, that some firms might prefer a set of contracts that replaces the market for control and fiduciary duties with other devices for ensuring that managers act in investors' interests. A high debt/equity ratio is one such set of contracts. This governance form places the equity in the hands of a coherent control group, which usually includes incumbent management, and replaces the rest of the equity contracts with debt contracts. Debtholders, instead of relying on a general management duty to maximize returns, are normally entitled to repayment of principal at a certain time prior to liquidation and to regular interest payments. These obligations are enforced by an indenture trustee, which mitigates the problems of monitoring by dispersed small investors, and are backed by "covenants," or contractual terms designed to limit the actions managers can take. Because debt holders rely much less on managerial discretion than do equity holders, they do not need either fiduciary duties or the power to vote on specific transactions or the election of directors. In short, monitoring of management under a debt-heavy capital structure may be cheaper and more effective than monitoring under an equity-heavy structure.

The high-leverage governance form is no more suited to every corporation than is the equity-dominated contract. In the first place, debt holders, who earn a fixed rate of return, would want their managers to pursue ventures that will safely produce sufficient income to pay off the debt rather than engaging in highly risky ventures that might be either extremely profitable or dismal failures. On the other hand, equity holders would want the managers to take some risks because they capture the benefits of profitable investments. Where the nature of the firm is to pursue very risky investments, such as a start-up biotechnology firm, the disparity of incentives between managers and debtholders may be so great that a debt-heavy capital structure is less efficient than an equity-heavy structure.

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[2] 488 A.2d 858 (Del. 1985).

[3] See, e.g., Del. Stat. Ann. tit. 8 Section 102(b)(7) (Supp.1988).

High leverage may also be inefficient for firms that expect unstable earnings or to engage in new projects, and also expect to have difficulty raising additional capital in the equity market, as may be true for a relatively unseasoned company.

Thus, for some firms, the costs of a high debt/equity ratio may outweigh the benefits. Such a firm may then adopt one or more of a number of other devices that provide at least some of the advantages of debt without all of the costs. For example, a publicly traded limited partnership, dual-class common stock or golden parachutes all protect managers from takeover risk without tying up cash flows to the same extent as a high debt/equity ratio. A firm might adopt one of those devices if a debt-heavy capital structure is inefficient but, at the same time, the benefits of insulating the firm from takeovers outweigh the costs.[4]

A high debt/equity ratio can, then, play a positive role in the governance of some, but not all, firms. It is simply one of many different combinations of contract terms -- as many as there are different companies, with different business needs.

B. The Social Cost of Debt: Failure and Restructuring

It has been said that "too much" debt is risky for society because it drives companies to the brink of collapse. However, this criticism evaporates in the light of the role of debt in the mix of corporate contracts.

In the first place, as we have seen, debt does not, itself, fundamentally change a corporation's business; it is simply one way of allocating cash to corporate investors. In fact, by reducing management "slack," increased leverage may make the firm more efficient. Among other things, managers have less leeway to involve the company in costly new projects. Thus, although a more highly levered company is more susceptible to economic shocks than a company with low debt, the shock is less likely to occur to the highly levered company.

Second, if the firm becomes unable to meet its interest payments, the result is not necessarily an end or even a shrinking of the company as a going concern. The inability to meet interest or repayment obligations simply provokes renegotiation of the corporation's contracts. If the firm is worth more as a going concern, it will be in all the parties' interests to keep the business going in order to get paid. And if the parties cannot achieve this result by negotiations outside of bankruptcy, they can do so under the legal pressure of a bankruptcy action.

If the company is worth less to reorganize and continue than it is to break up, the same circumstances probably would have led to break-up even if the firm had been able to pay its debts. What is important to recognize is that the only thing insolvency adds is the need to renegotiate and restructure contracts.

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[4] See Larry E. Ribstein, An Applied Theory of Limited Partnership, 37 Emory L.J. 835 (1988).

Of course, the costs of restructuring may be steep.[5] That may be primarily because of the rules governing bankruptcy itself. Among other things, bankruptcy rules make reorganization costly by replacing governance by owner voting and the market for control with governance under court supervision. Moreover, the parties may have perverse incentives to resort to this costlier form of governance because the Bankruptcy Code makes some parties better off and others worse off than they would be outside of bankruptcy.[6]

To the extent that bankruptcy rules inefficiently inhibit restructuring, they also make debt costlier than it needs to be. The solution is not to ratify this inefficiency by limiting debt, but to eliminate the root cause of the problem by reforming bankruptcy.

III. Leveraged Buyouts and Corporate Governance

A. The Positive Role of Leveraged Buyouts

Leveraged buyouts are the most important method of changing the capital structure of a corporation. There are, of course, many other ways, including debt-financed distributions and exchange offers. But a full-fledged leveraged buyout, which usually includes at some stage the creation of a new corporate entity through a merger or asset sale followed by dissolution, accomplishes the complete substitution of debt contracts for most equity contracts of the target shareholders.

Another important aspect of leveraged buyouts is that while other methods of increasing leverage can be ordered only by incumbent managers, a leveraged buyout can be initiated through a tender offer by anybody. Therefore, the leveraged buyout can be a potent device for policing management decisions, including management's failure to increase leverage.

B. The Costs of Leveraged Buyouts: Who Gets Hurt?

There is a strong belief afoot that leveraged buyouts redistribute rather than create wealth, damaging both parties to the target corporations and society as a whole. Suspicions are raised, among other things, by the huge premiums paid in leveraged buyouts, the frequent involvement of insiders, and the large profits and fees earned by those who engineer these transactions. Closer examination, however, reveals the dominance of the efficiency-enhancing explanation of LBO's.

1. The Tax Explanation of LBO's

The money earned in LBO's is often attributed to the tax savings from increasing tax-deductible interest payments. Under this story, the recent increase in LBO activity was caused by increases in the tax benefit from debt under the Tax Reform Act of 1986 by changing the ratio of corporate to individual rates and eliminating the tax break for gains on stock sales.

But this story ignores the changes that the 1986 Act made that were negative for buyouts, including higher taxes on gains from stock sales and the repeal of *General Utilities*. Thus, the Jensen, Kaplan and Stiglin study concludes that LBO's are probably costly to the participants from a tax standpoint.[7] If that study's conclusion is correct, we must take seriously the possibility that the efficiency-enhancing aspects of leveraged buyouts outweigh the tax disadvantages.

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[5] See David M. Cutler and Lawrence H. Summers, The Costs of Conflict Resolution and Financial Distress: Evidence from the Texaco-Pennzoil Litigation, 19 RAND Journal of Economics 157 (1988).

[6] See generally, Thomas H. Jackson, The Logic and Limits of Bankruptcy (1986).

There are recent events other than tax changes that might account for the increase in leveraged buyouts consistently with the efficiency-enhancement explanation. For example, the fiduciary duties of both managers and outside directors have been intensified. The Delaware courts have held that managers breached their fiduciary duty when they approved a sale of the company[8] and when they did *not* sell.[9] These c~~ases toget~~her "up the ante" for managers of open corporations with dispersed shareholders. Managers can escape this risk only by going private.

Second, to the extent that the gains from insulating managers from the market for control outweigh the losses from a decrease in monitoring, leveraged buyouts have become more attractive as alternative avenues of insulating managers have been foreclosed. For example, the S.E.C. recently promulgated a rule limiting dual class recapitalizations which, like management buyouts, lock control in managers.[10]

All of this is not to conclude that tax considerations are irrelevant. The study referred to above indicates that tax rules may deter efficient LBO's. On the other hand, that study's conclusions may be wrong and some LBO's may be motivated by tax considerations, at least in conjunction with efficiency considerations. If so, perhaps the recent surge in LBO activity is partly attributable to the closing of alternative methods of tax avoidance. Most importantly, some firms that once would have disincorporated into publicly traded limited partnerships may now be escaping double taxation (as well as obtaining the management-insulation advantage of limited partnership)[11] by doing leveraged buyouts. Whatever the correct conclusion, the lesson to be drawn is not that LBO's are, in general, bad or good, but that tax rules are leading to inefficient governance arrangements. As discussed in Part IV, below, the solution is tax neutrality, not more manipulation of corporate governance.

2. Injury to Selling Shareholders

Surely it would appear that the least sympathetic candidates for victim status are the selling shareholders. The selling sharholders usually earn huge premia in the buyout,[12] and indeed would be expected to benefit from the market discipline leveraged buyouts provide for corporate managers.

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[7] See Michael C. Jensen, Steven Kaplan and Laura Stiglin, Effects of LBOs on Tax Revenues of the U.S. Treasury (mimeo, 1989).

[8] See n.2, above and n. 14, below.

[9] See n.13, below.

[10] S.E.C. Rule 19c-4, 53 Fed. Reg. 26,394 (1988).

[11] See n.4, above.

[12] See Kenneth Lehn and Annette Poulsen, Leveraged Buyouts: Wealth Created or Wealth Redistributed? In *Public Policy Toward Corporate Mergers*, M. Wiedenbaum and K. Chilton, eds., Transition Books, New Brunsick, N.J.

The lingering suspicion that selling shareholders are victimized appears to spring largely from the huge profits sometimes earned by the post-buyout investors. These profits imply that the shareholders were forced to sell at a "bargain" price, that the promoters used inside information, or that the promoters are simply "unfairly" expropriating gains that belonged to the pre-buyout shareholders.

There is a benign explanation of the post-buyout profits and little reason to suspect unfairness. The investments of the post-buyout shareholders are simply not comparable to those made by the pre-buyout shareholders. First, the post buyout shareholders are much more susceptible to small changes in cash flows because of the heavy leverage. In other words, they bear a larger proportion of the risk of the firm than did the selling shareholders. Therefore, the risk-adjusted post-buyout equity returns are not as high as they might appear.

Second, the post-buyout company is more productive because the new high-leverage capital structure increases the managers' incentives to maximize productivity. In other words, the post-buyout returns were simply not available to the selling shareholders because they are partly attributable to the elimination of dispersed public investors.

Third, the post-buyout returns to equity partly compensate for additional monitoring functions performed by the new equity holders that were not performed by the selling shareholders.

Critics of leveraged buyouts might claim that it is not "fair" that managers are getting paid more after the buyout for what they "should" have done before the transaction. In the end, however, critics of LBO's must remember that the benefits produced by leveraged buyouts will not simply materialize if rules are enacted limiting LBO's or reallocating premia from them. If LBO's are eliminated, this will exacerbate the management incentive problems that must exist in an imperfect world. And if increased post-buyout returns must be allocated to the selling shareholders, the transactions will not happen because promoters and managers will not promote LBO's unless the risk-adjusted return from the time, effort and capital they invest in these transactions exceeds their opportunity costs for these resources.

The only ways in which LBO promoters can indeed "steal" the company for "bargain" prices are if inside information about the target is not disclosed, or management is able to bypass shareholder approval of the transaction. The inside information problem cannot be serious in these transactions. Abuse of inside information by corporate managers is forbidden both by the federal securities laws and by the state law fiduciary duties that are an implied part of the corporate contract. Moreover, even if the managers wanted to hide information, that would be difficult to do in light of intense scrutiny of the target by securities analysts and potential bidders. Finally, there is little problem in enforcing insider trading restrictions against corporate managers in leveraged buyouts because their participation in the transaction is notorious and their guilt will be starkly revealed as soon as the information is disclosed.

In the absence of inside information, the efficient securities markets fully reflect information about the target. The purchaser therefore cannot be buying at a "depressed" price, because that implies knowledge he does not have about the future.

The other barrier to "bargain" purchases is that the managers do not have the final say in deciding on these transactions. This has been the clear direction of state court decisions, particularly in Delaware. As was made clear by the failed management bid in the RJR-Nabisco situation, the managers must deal with independent outside directors. Moreover, even the outside board members cannot foreclose an open auction for the company either by forcing their own restructuring on the shareholders[13] or by locking up an auction with a white knight,[14] at least unless the managers have clearly maximized shareholder value.

3. Purchasing Bondholders

Nor are the purchasing bondholders injured. The strong presence in the bond market of sophisticated players, including mutual and pension funds, ensures that the bond contracts are carefully drafted to protect investors and priced so that their yield reflects their risk.

4. Existing Creditors

Critics of LBO's suspect that the increased debt in these transactions must injure existing creditors. In fact, the evidence points the other way.[15] If, indeed, leveraged buyouts improve the efficiency of the post-buyout company, there is reason to believe that existing creditors would be helped rather than injured. It is, in short, a mistake to focus on the size of the equity "cushion" or the coverage ratio because these "protections" can be readily dissipated by inefficient management.

The more important point is that even if there were clear evidence of bond price declines in leveraged buyouts there would still be no cause for concern. Increasing debt through a leveraged buyout is one of a great many manifestations of the conflict of interest between equity and bondholders. Bond contracts cannot eliminate these conflicts. Rather, the contracts are drafted to achieve the optimal balance, in light of the circumstances of the particular company, between the risk-preferring interests of the equity holders and the risk-avoiding interest of the debt holders.[16] Gaps in protection are reflected in the price of the bonds. It follows that where a transaction injures debt holders but is not forbidden by their contract, there is a strong possibility that this is consistent with the price-protection tradeoff inherent in the contract.

In all events, the bondholders are protected under state law even beyond the express terms of their contracts by the law of fraudulent conveyances,[17] and by a few cases that appear to recognize fiduciary duties to bondholders.[18] These protections provide rules covering the many situations the parties cannot anticipate in their contracts. Fraudulent conveyance law is particularly useful protection for trade creditors and others for whom it would be excessively costly to contract in detail for protection. Fiduciary duties to bondholders are more questionable in light of the explicit nature of bond contracts, but may serve to cushion debt instruments from the rapid pace of financial innovation. In any event, state law should be permitted to evolve toward an appropriate rule that takes into account specific circumstances and the terms of the parties' contracts.

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[13] See City Capital Associates Ltd. Partnership v. Interco, Inc., [Current] Fed.Sec.L.Rep. (CCH) para. 94,084 (Del. Ch. Nov. 1, 1988).

[14] See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del.1986).

[15] See Lehn & Poulsen, n. 12, above.

[16] See Clifford W. Smith & Jerold B. Warner, On Financial Contracting: An Analysis of Bond Covenants, 7 Journal of Financial Economics 117 (1979).

[17] See U.S. v. Gleneagles Inv. Col, 565 F.Supp. 556 (M.D.Pa. 1983); Baird & Jackson, Fraudulent Conveyance Law and its Proper Domain, 38 Vand. L.Rev. 829 (1985); Note,

In light of the empirical evidence on effects of LBO's on bondholders, their explicit contracts and evolving broad state law protection, there is absolutely no reason to legislate protection for creditors in leveraged buyouts. Moreover, even if bondholders have been hurt in the past, purchasers in future bond offerings clearly do not need regulatory protection. If creditors now deem leveraged buyouts to be a risk worth taking into consideration, they may insist on covenants in future bond instruments that, for example, give them a right of redemption in the event of an LBO.

5. Employees and Local Communities: The Problem of Dislocation of LBO Targets

While firms sometimes move or fire employees in the wake of an LBO, it would be a serious mistake to regulate LBO's for this reason. First, since leveraged buyouts increase efficiency, hirings are as likely as firings. This is particularly likely where an LBO has been used to acquire a division from a conglomerate and revitalize it under independent management.

Even where dislocation does occur following an LBO, the LBO itself is not the culprit. A leveraged buyout does not create a new business, but only financially restructures the old one. If pieces of the business are sold or employees fired after the buyout to pay the debt or interest, that must be because these transactions increase the value of the firm. It follows that these events would have occurred eventually as long as the managers are maximizing profits, which the takeover market will prod them to do.

The LBO adds only the ingredient of new debt which bonds the promoter's promise to the new investors that the changes will be made. This bond, in turn, increases what the investors are willing to pay for the investment. This is simply another version of the story that leveraged buyouts enhance management efficiency.

It is ironic, in fact, that leveraged buyouts should be the focus of concern about dislocation of employees. Corporate consolidations, which do not depend on debt, do create new firms and are likely to cause layoffs to eliminate redundancies. Indeed, leveraged buyouts, by reducing cash available for expansion, may have reduced corporate consolidation. Moreover, as discussed above, divisional LBO's have unwound inefficient conglomerates, making the separate divisions more productive. If anything, restricting leveraged buyouts may actually cost jobs.

Fraudulent Conveyance Law and Leveraged Buyouts, 87 Colum.L.Rev. 1491 (1987).

[18] For a review of cases arguably recognizing a fiduciary duty see Morey McDaniel, Bondholders and Stockholders, 13 J. Corp.L. 205 (1988).

The real issue concerning LBO's and dislocation may lie below the surface. Perhaps critics of LBO's believe that LBO's are doing too good a job of focusing management's attention on corporate profits. In other words, the fundamental policy question here may be whether employees and local communities should be legally entitled to binding commitments from corporations, even at the cost of increased corporate productivity.

In addressing this question, we move far afield from LBO's. Binding commitments, if they are appropriate, should be provided through specific laws that would apply to all corporations irrespective of their financial structure. Trusting management discretion would be a serious mistake because distracting managers from profits only makes everyone worse off by increasing management incentive problems. In other words, permitting the managers to respond to all members of the corporate community leaves them free to respond to none. In all events, if we want to change the mission of corporate management we should do so directly. Restricting LBO's evades the real questions and may do more harm than good.

6. Effect of Leveraged Buyouts on Research and Development

The threat of LBO's is said to focus managers' attention on the short-run by exposing them to the mercy of the short-sighted securities markets. Moreover, in the post-LBO company, research and development funds are said to be pre-empted by debt service obligations.

These criticisms are misguided. In fact, both the takeover threat posed by LBO's and the debt service obligation have salutary effects on research and development by constraining managers to allocate research and development funds wisely. Because a firm's R & D investments are evaluated just as accurately by the securities markets as the company's other projects, the threat of an LBO will only deter wasteful investments. After the LBO, even if cash is tight, the managers can always fund R & D projects by convincing the capital markets that the projects deserve funding.

Once again, the real issue here may be the fundamental one of management's mission rather than the effect of LBO's. Perhaps the concern is that LBO's cause firms to cut back on research that is not profit-maximizing but does benefit society. Again, it is necessary to confront this alleged problem directly. If there is a problem, perhaps the solution is reducing regulation that cuts the potential profits from research and development. But in all events, restricting LBO's evades, rather than solves, the problem.

7. The Risk of Collapse

It is said that employees, creditors, communities and others are injured by leveraged buyouts because these transactions increase the risk of insolvency. As discussed above, there is no need to be concerned about costly collapse resulting from a high debt/equity ratio. Beyond this, there are extra safeguards built into leveraged buyouts. Promoters select LBO targets for stable earnings and established product lines that have high resistance to economic shocks. Leveraged buyouts also can be structured to minimize the danger of insolvency. One technique, which was used in the RJR-Nabisco buyout, is to finance the buyout partly with an instrument called "exchangeable preferred stock." This security provides for dividends during the early post-LBO stage, which can be omitted without triggering insolvency. Later, when the company proves that it can comfortably pay interest on its debt, the managers can exchange the preferred for more debt.

In general, LBO promoters have strong incentives to engineer failure-proof buyouts because they are "repeat players" in the leveraged buyout market whose reputations would be tarnished by the failure of an LBO target. Moreover, some promoters, like Kohlberg, Kravis and Roberts, are substantial investors in their deals. Thus, those who arrange LBO's are generally more averse to the risk of failure than managers who are increasing the debt of their corporation outside of an LBO.

8. Transaction Costs of LBO's

Opponents of leveraged buyouts often cite the enormous fees these transactions generate for investment bankers, lawyers and others. But the concern that the fees are "too high" ignores both the intense competition in the financial markets and the services performed by these parties, including extensive recent innovations in corporate finance.

If there is a problem concerning high fees, it may be one that calls for less, rather than more, regulation. Increased regulation of takeovers, including the Williams Act, state anti-takeover statutes, common law fiduciary duties and constantly evolving tax provisions increases not only compliance costs but also risk, since there are more ways for the deal to go wrong. To some extent, the fees in takeovers represent a risk premium charged by the participants to compensate them for busted deals and to internalize the risk of legal liability. Risk also explains the enormous gains of arbitrageurs, who buy stock below the offer price and reap the gain between their purchase price and the price of the eventual deal. The "arbs" in effect insure the selling shareholders against the risk that the deal will fall through. Their profit is an insurance premium.

There is also a concern that high transaction fees are inducing the wrong kinds of LBO's. Treasury Secretary Brady testified that those who are earning the fees, including the sponsor and investment banks, "may have relatively little, if any, investment in the long-term success of the new enterprise. Given this arrangement, it may very well be that the net effect of LBOs is a financial snipe-hunt, where the new long-term investors, flashlight in hand, are left holding the bag."[19] But Secretary Brady ignores the fact that, as stated earlier, those who arrange these deals have incentives to ensure that the deals are strong. From this perspective, the high fees, rather than encouraging bad deals, represent a kind of "bond" that the arrangers might forfeit if their deals turn sour.

IV. The Need for Tax Reform

A. Perverse Incentives of Current Tax Rules

The above discussion makes clear that the efficient level of debt in a particular company, as well as other aspects of the contracts among the parties to the firm, is a matter of sensitive tradeoffs of costs and benefits specific to that firm. The problem is that current tax rules influence these choices, and therefore may cause firms to engage in transactions or adopt governance contracts that would be less efficient than available alternatives in the absence of tax benefits. These "second-best" alternatives trade higher operating costs for lower taxes. In other words, taxpayers are paying for inefficiency.

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[19] Testimony by Treasury Secretary Nicholas F. Brady Before the Senate Finance Committee, January 24, 1989.

The following features of our current corporate tax system are the most relevant to corporate governance: (1) taxation of corporate income both when earned by the corporation and when distributed to shareholders as dividends or realized through the sale of their shares; (2) deductibility of interest payments; (3) a corporate tax rate that is above the tax rates of most shareholders; and (4) taxation of gains on stock sales at ordinary income rates.

This combination of circumstances has several important consequences. First, most investors will be better off investing in "flow-through" forms such as partnership or in highly leveraged corporations than in low-leverage corporations. Although the corporate form does offer the potential advantage of deferring tax until the investor sells, in light of the current capital gains rate and the tax rates for corporations and individuals, retention does not help the many shareholders whose personal tax rates are below the corporate rate and who will eventually incur tax by selling.

Because of the tax incentive to invest in flow-through business forms, the Code in effect penalizes adoption of the governance terms that the Code classifies as constituting a corporation: continuity of life, centralized management, limited liability, and free transferability of interests.[20] More recently, the Code was amended to treat as a corporation any "publicly traded partnership" formed after December 17, 1987 unless its gross income consists mostly of dividends, rents and other "passive income."[21]

The effect of penalizing selection of these "corporate" characteristics is that some firms for which these terms are efficient in a world without tax may adopt a second best form, such as partnership, and offset the non-tax costs against the benefits of flow-through taxation. For example, a firm may forego the advantages of public ownership -- advantages that include efficient market pricing and diversification of risk by investors -- because these advantages are outweighed by the tax costs of being classified as a corporation. Instead, the firm might place its interests with only a few investors and adopt two or more "partnership" characteristics, such as restrictions on transferability and a limited partnership structure with personal liability of general partners.

For its part, the incentive to increase leverage in order to mitigate the effect of the double tax encourages firms such as growth-type companies with unstable cash flows to use debt even if a high debt/equity ratio would be inappropriate. In effect, these companies offset the cost of debt against tax benefits.

Because adoption of a flow-through form and increased leverage are alternative routes to tax avoidance, tax rules affecting one may encourage use of the other. For example, as discussed earlier, the closing of the public limited partnership option may have encouraged more leveraged buyouts. If so, this is an example of tax rules encouraging perverse choice of form. The limited partnership form may be a more appropriate way for some firms to escape the burdens of double taxation than leveraged buyout because a limited partnership can design a flexible payout program that avoids the potential hazards of heavy debt.

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[20] See Treas. Reg. Section 7701-1 et seq. (1987) (referred to collectively as the "Kintner regulations"). The applicable Code provisions, which define "partnership" and "corporation," are I.R.C. Section 7701 (a)(2), 7701(a)(3)(Supp. 1986).

[21] I.R.C. Section 7704 (West Supp. 1988).

For some firms the advantages of incorporating with low leverage may outweigh the tax costs of this structure. In these companies the corporate tax encourages retention of earnings to mitigate the impact of the double tax on shareholders. In other words, retention may be better than distribution even if the company lacks opportunities to use the cash productively. Thus, the tax law exacerbates the conflict of interest between managers and shareholders by partially subsidizing management inefficiency in using the retained funds.

Finally, the current tax structure, contrary to popular belief, may actually create a disincentive to buyouts. As discussed immediately above, retention of earnings is the best way of mitigating, by delaying, the shareholder-level tax on corporate earnings. The delay ends when the shareholder must pay tax on sale of his shares (unless the sale is by installment in a close corporation). This tax may even outweigh the benefits from moving to greater leverage. From the standpoint of corporate governance, this system dampens the market for corporate control, and therefore lessens market constraints on management misconduct, by increasing the premium a cash tender offeror must offer to gain control.

B. An Evaluation of Alternative Tax Changes

The tax laws should be changed to end these perverse tax influences on corporate governace. The following is an evaluation of some alternative proposals.

1. Flow-through or Integrated Taxation

The only complete solution to the problems just listed is the elimination of double taxation, so that corporate income is taxed directly to the shareholders. This could be done either by taxing all firms as partnerships are taxed now, or through devices like deductions for dividend payments. This approach would avoid tax incentives to carry excessive debt, to retain earnings or to adopt inappropriate business forms, and would end the penalty on stock sales.

The two-tier system of corporation taxation has been around for so long and is such an accepted part of our tax system that it might seem heretical to suggest eliminating one tier. But, from a theoretical standpoint, there is absolutely no reason to distinguish for tax purposes between corporations and non-corporate forms of business. A corporation, like a partnership, is simply a set of contractual terms. Indeed, the infinite variation of governance terms both of corporations and partnerships make precise categorization impossible. While it may be convenient to think of the corporation as a separate legal entity for some purposes, such as for titling of property and litigation procedure, the very same reasons justify entity treatment of partnerships.[22] The artificiality of the distinction on entity grounds is demonstrated by the tax regulations governing the distinction.[23] For example, it is difficult to understand how public trading of interests, which was stressed in the recent tax provisions, relates to classification of a business as an entity.

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[22] See Alan R.Bromberg and Larry E. Ribstein, I Bromberg & Ribstein on Partnership, Section 1.03 (1988).

[23] See n. 20, above.

Although detailed discussion of tax policy is beyond the scope of this paper, it is worth noting that it is far from clear that taxing income on a flow-through basis would have a negative impact on revenue. The trend toward increased leverage reduces the tax at the corporate level, while ownership by tax-exempt entities reduces the impact at the individual level. Most importantly, reducing tax manipulation of governance will almost certainly have a positive effect on corporate profits that should be taken into account in assessing the revenue implications of this change.

Elimination of the double level of taxation is the best method of ending perverse tax effects on corporate governance. This can be seen clearly by examining several incomplete "second best" alternatives.

2. Eliminating or Reducing Interest Deduction

Making interest payments non-deductible or setting a ceiling on the amount of interest that may be deducted would certainly reduce the incentive to increase leverage for tax reasons. The problem, of course, is that this change would also markedly increase the incentive to avoid the corporate form. Although the public limited partnership route has been closed, other ways to avoid the corporate penalty remain open, such as REMICS and REITS. Creative lawyers and investment bankers will undoubtedly invent new approaches if pressed to do so. Moreover, firms that choose to remain incorporated despite the increased penalty would be induced to opt for greater retention of earnings. All of these options may be "third best" alternatives that are even less efficient than debt, and make sense only in light of tax benefits.

3. Eliminating Interest Deduction on Certain Instruments: The Debt/Equity Distinction

Tax incentives to increase debt may be reduced by classifying instruments that are nominally "debt" as "equity" for tax purposes. But any efforts along these lines erroneously assume some fundamental distinction between these categories. In fact, the parties to governance contracts potentially can negotiate any conceivable mix of payment obligations, negative covenants prohibiting certain transactions, convertibility, exchangeability and monitoring devices, to name only some of the variables. There is no point at which these terms become either "debt" or "equity" in any absolute sense because, tax considerations aside, these categories are not relevant to the negotiations. In other words, the tax distinction is unavoidably arbitrary.[24]

Any attempt to distinguish "debt" and "equity" inevitably raises a problem of perverse effects. Wherever the line is drawn, firms will have strong incentives to fall on the correct side. If the distinguishing characteristic is interest rate (i.e., an anti- "junk bond" rule), this may cause firms to substitute negative covenants. But negative covenants may unduly hamstring the managers of new, growth-oriented companies. In the absence of tax incentives, the company may have been willing and able to negotiate with creditors a higher interest rate instead of the covenants.

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[24] See I.R.C. Section 385. Although this provision was added in 1969 and called for the adoption of regulations distinguishing debt and equity, none were proposed until 1982, and these were withdrawan.

4. Eliminating or Reducing Interest Deductions for Debt Issued in Certain Transactions

Eliminating deductibility of certain acquisition indebtedness may be the worst of all possible tax changes. Athough companies may continue to restructure, these changes will have to come from management. Thus, this kind of rule may short-circuit the takeover market as an effective device for policing managers, including management-initiated changes in the capital structure. Increased leverage is often not in the managers' interests because the duty to make heavy interest payments and the specific negative covenants in the debt instruments take control over corporate cash flows from the managers. Leveraged buyouts by outsiders are the best way of ensuring that capital structure changes will be made when it is in the shareholders' interests to do so.

5. Deductibility of Dividends

Permitting deduction at the corporate level of dividend payments, or allowing a credit at the shareholder level for tax on corporate earnings would, like eliminating deductibility of interest, reduce firms' incentive to load up on debt. But this alternative is vastly preferable to the elimination of the interest deduction because it also reduces the corporate tax penalty and perverse tax incentives regarding choice of form. Deductibility of dividends is also preferable to eliminating interest deductibility because it would reduce the tax incentive to defer taxes at the shareholder level by retaining earnings.

V. Conclusion

Leveraged buyouts and the increase in corporate debt can be sensibly evaluated only in the context of the complex choices firms make in developing governance arrangements. The Committee should take this opportunity to recognize the extent to which corporate governance terms may be induced by irrational tax law distinctions. In the final analysis, the only way to ensure corporate efficiency is to eliminate perverse tax incentives. The Committee should move in this direction.

Chairman ROSTENKOWSKI. I guess the question that I am going to ask would be directed to you, Professor Jensen, and you, Professor Ribstein. Each of you advocate some form of relief for dividend payments. What would you do about a negative revenue implication of a dividend payment relief? Are you suggesting that there will not be a negative dividend payment?

Mr. JENSEN. I have not studied the problem enough to give you a firm opinion on that. What I do believe though is that there is a very large potential revenue source out there that has to do with removing one of the most important inefficiencies in corporate America today that, as far as I can tell, no one who is involved in the tax business has really paid much attention to. Maybe Alan or Professor Andrews will correct me because they are much more closely involved in that analysis than I am.

The problem that I am talking about is what some of us have labeled sort of the free cash flow problem, trapped equity. It is one of the reasons why you get very strong pressure from corporate America to not do things that will make it easier to bring about these payouts.

I agree almost 100 percent with what Professor Andrews is trying to accomplish in terms of the goals. One of the unfortunate things that I think will happen with at least some of his options is that we will look in, we will build concrete walls around old line, inefficient, diversified corporations. Most of the Fortune 500 perhaps fall in that category now in terms of having far too much capital, whereas other places in the economy do not have enough.

One of the things we have been observing, and I think the integrating theme that allows us to explain an enormous amount—not all, but an enormous amount of what has been going on in the last decade, decade and-a-half in the corporate control market is really a response, both in the oil industry, in the tobacco industry, in the food industry, in forest products, to trying to get trapped equity capital out of these that is being inefficiently used, wasted. And that is one of the sources of the tax gains that I estimated.

I cannot tell you, because I have not done enough work, what that revenue implication would be. I think it is large. I cannot tell you today how to reorganize the whole Tax Code in order to move from where we are now and eliminate this double taxation of dividends. But I think it is a very important thing for us to do.

Chairman ROSTENKOWSKI. Professor Jensen, we are not going to reorganize the Tax Code, I promise you that.

Mr. JENSEN. I am glad you are not asking me to do that then.

Chairman ROSTENKOWSKI. What do you think, Alan? Would you like to make an observation about what Professor Jensen——

Mr. AUERBACH. About what increased dividend relief would do in terms of revenue?

Chairman ROSTENKOWSKI. Yes.

Mr. AUERBACH. The only concrete estimate of which I am aware is, for the coming fiscal year, is way back in 1984 the Treasury had proposed a 50-percent dividends paid deduction. And the estimated revenue cost then for fiscal year 1990 was $31 billion for a 50-percent dividends paid deduction.

Chairman **Rostenkowski**. Would you yield to my colleague, Mr. Pickle? He is going to go through the ceiling if he does not say something here.

Mr. **Auerbach**. Sure.

Mr. **Pickle**. I just want to enter into this dialog and the question I was going to ask is along the same line. Let me put it a different way. All three or maybe four of you professors said we ought to do away with this double taxation of dividends. I think the Congress would like to do something about it. It is going to cost us in the budget. And when the chairman asked you would it be a budget negative impact, of course it would be tremendous. You know that is going to be a hell of a jolt for our budget.

My question deals with it differently. Suppose the double taxation of dividends is removed. What effect would that have on debt financing? Any of you can take a crack at that one.

Mr. **Jensen**. I think it would be lower than it otherwise would be, but it is not going to push you back to where it was before. That is not going to happen.

Mr. **Pickle**. Then it basically would not have any effect by itself if you just did that. Suppose you got what you wanted, what would that do to debt financing?

Mr. **Jensen**. I think it would push you back. We would have less debt than we would otherwise have under the current Tax Code. But no way would we go back to the old days of 20-percent debt-equity ratios. We are moving down this road, and I think it is healthy.

Mr. **Pickle**. Professor Warren had said that we ought to have some leveling between debt and the deduction of interest and I believe that Mr. Ribstein did, too.

That sounds good though. How would we approach that? I do not think this committee or the Treasury is going to give dividend relief and not make up for that lost revenue. It will not have any effect basically on debt financing.

So we are faced with cold facts. Where are we going to get the money? I am searching for some way, if we are looking for a level playing field, how do we balance the two, interest and the dividends? What figure can we propose?

Mr. **Warren**. I do not have a specific figure to propose, but I certainly agree with your statement and the chairman's that starting integration would be extremely expensive. It seems to me that is one reason the committee should think about simultaneously limiting interest in some way.

But also I would also suggest that your committee should think seriously about taxing that part of the corporate income flow which is not now taxed to the corporation nor taxed to the receiving investor. For example, foreign shareholders who pay no taxes either on interest they receive or on capital gains from sales of American securities. It seems to me that such investors might provide part of the answer also in terms of revenue.

Mr. **Pickle**. If I may make one summation statement, Mr. Chairman.

Chairman **Rostenkowski**. I did not yield to you. You will get your own time.

Mr. **Pickle**. All right.

Chairman ROSTENKOWSKI. With respect to capital gains, do you think that a reduction in the 1986 capital gains tax rate would reduce revenues to the Federal Government? And do you think such a cut could possibly increase LBO activity?

Mr. AUERBACH. If I could just ask a clarifying question. Are you talking about a cut, for example, of 15 percent tax rate?

Chairman ROSTENKOWSKI. In the neighborhood of what some people in Washington are talking about.

Mr. AUERBACH. Just for example. I think it is fair to say, one ought to be unsure about the numbers. But my best guess would be that a cut in capital gains tax rates now, as many people have suggested, would probably lose several billion dollars this year and for each year in the foreseeable future.

One might by altering the timing of the introduction, there are tricky ways to get revenue to go up in the first year and go down more in future years. There are ways to make the revenue loss bigger or smaller by limiting the coverage in terms of assets. I think it is very hard to argue that there is a sustainable increase in revenue that would come as a result of capital gains tax cuts. I think it is unfortunate that that is the primary focus or the primary argument used to support such cuts. I think if capital gains taxes are cut, there ought to be other arguments in favor of that being done.

On the second part of the question concerning whether LBO's could be increased by a cut in capital gains taxes, it is certainly possible because while cutting capital gains taxes in the long run levels the playing field between debt and equity just as cutting the double taxation of dividends would, in the short run a reduction in capital gains taxes would lower the tax hurdle over which deals have to go in terms of the up-front taxes that are paid by shareholders and companies being taken private. It is quite possible that a substantial reduction in capital gains taxes could have as a side effect that outcome.

Chairman ROSTENKOWSKI. I will not use any more time, but I am quite concerned with the big event that is going to take place on February 9 here. We went through hell and high water in this room trying to eliminate the differential. I am afraid that we will start unraveling some of the strong commitments we made to a lot of people.

Do not misunderstand me. There are some people on both sides of the aisle here that disagree with me. But as to the effects of the Reform Act of 1986, I think this is the first year where we are going to see the true evidence of whether or not tax reform was done so that people would have a stable idea of what the code is going to look like. So I am trying the best way I know how to get somebody's attention in the economic dynasty down at 1600. But we will see.

Mr. Pickle.

Mr. PICKLE. I will be interested also on February 9 if the recommendation is made to lower the capital gains tax rate to 15 percent which I would basically be for. But I would like to know what money is involved. We do not have any figure on it yet and I hope the President, if he makes that recommendation, or the Treasury, will give us those figures. You said several billion. That does not mean very much to me. I would like to know specifically.

But let me ask all of you one question. In the RJR Nabisco-KKR transaction, do any of you think that transaction would have gone forward if they had had any kind of reasonable control on interest deductions? Do you think that transaction would have come about if there had been a balance of interest deductions against deductions on dividends.

Mr. JENSEN. Yes.

Mr. PICKLE. You think that if the Tax Code was not being used and if interest could not be fully deductible that the Nabisco deal would still have gone forward? Do any of the rest of you agree with that?

Mr. JENSEN. I misunderstood your question. I thought you were asking, if there was equivalent treatment between dividends and capital gains would that transaction—dividends and interest, would that transaction have gone forward. Yes, it would. The price may be different.

Mr. PICKLE. I guess what I am——

Mr. JENSEN. Because the main thing driving that transaction is the increases——

Mr. PICKLE. Let me put it in my language. It would seem to me that we all would have to admit that the use of high deductions for interest paid is the fuel that fires up these engines for these LBO's. That has to be the biggest factor in there.

Now if we take some kind of control over it and we give dividends a similar deduction, then we can take the Tax Code out of these LBO's. If I can find a way to do that, try to make the Tax Code neutral, then that is what I am going to try to be for. How we do it is going to be our problem, but surely the interest is one of the biggest problems we have got.

Now, Mr. Chairman, I do not want to prolong this. We have been at this all day long. I will yield back my time and let Mr. Crane question.

Mr. CRANE. Thank you, Jake.

Professor Auerbach, did you say that Treasury projected from 1981 to 1990 that if you had eliminated double taxation of dividends it would have constituted a $31 billion revenue loss?

Mr. AUERBACH. That was projected in the November 1984 study.

Mr. CRANE. Was that for the timeframe from 1984 to 1990?

Mr. AUERBACH. No, it was the 1 year revenue loss for fiscal year 1990.

Mr. CRANE. The reason I ask is that I have seen studies saying that taking the maximum capital gains rate down to 15 percent would generate an increase of $31.6 billion over a 3-year timeframe. It struck me that if they were looking at a timeframe like that, it might not be a bad tradeoff for trying to figure out how you offset the revenue losses.

But on the question of increasing capital or maintaining the increased capital gains rates—and correct me if I am wrong because these were presented to us as supposedly coming from Treasury. In 1968 when we had a 26.9-percent rate, that brought in $5.9 billion in revenue to Treasury. Then we went from 26.9 to 27.5 and the revenue gain revenue fell off to $5.3 billion. Then we went up to 32 percent and revenue fell down to $3.2 billion. In short, it took us 8 years, up to 1976 when the rate was finally up to 49 percent to match the 1968 revenue figures.

Then, in 1978, when our former colleague Bill Steiger pushed through the reduction to 28 percent, revenues went from $9.1 billion to $11.7 billion, to $12.5 billion, to $12.7 billion. Then in the 1981 tax bill when we pushed that rate down to 20 percent, the 1982 revenues went up to $12.9 billion, the next year to $18.5 billion, 1984 to $21.5 billion, and 1985 to $24.5 billion. I am not going to look at 1986 because that was skewed by people capitalizing on unloading assets before we hiked the capital gains rate so astronomically. It did jump to $46.4 billion, but I will concede that is an aberration.

I do not know what the revenue gains were in 1988? Does anybody have any idea?

Mr. AUERBACH. The tax revenues in 1988?

Mr. CRANE. Yes, capital gains revenues. They may not have those out yet. But I had heard that in a lot of States like Michael Dukakis' home State in which Professor Jensen lives and works, part of their fall-off in revenues was attributable to the hike in capital gains rates and that this affected other States as well.

It just seems to me that it is a foolish policy to tax capital gains at all or dividends at all. But this is something based on the historic record, always over Treasury's objections because they were always projecting revenue losses when we lowered those rates based primarily, I think, on their static analyses. But that is not supported by the record. We have got capital gains rates up now at unreasonably high levels, 28 and 33 percent for most investors, and taking those rates down would be a revenue raiser.

One other thing though in connection with how you offset, if we were to eliminate the double taxation of dividends. Have you any idea if we were to raise corporate tax rates, how many percentage points the rates would have to be raised to offset the anticipated losses to Treasury from elimination of the taxation on dividends?

Mr. AUERBACH. That would not be a hard analysis to perform, but I am afraid I could not do it right here.

Mr. CRANE. Do you think it would be more than a couple of points?

Mr. AUERBACH. I would guess that it would be, yes.

Mr. CRANE. I am not necessarily recommending this. But it just seems to me that to avoid tax-driven decisionmaking in the business community which I think there is pretty largely a consensus on your part should be done, it would be in our national interest to try to figure out how, in a way that is not totally disruptive of the marketplace, we could guarantee that equity is treated as fairly as we treat debt. I am just not sure exactly how to go about it, but I would hope you folks would not take a dim view of lowering the capital gains rate.

I thank you for your testimony.

Mr. JENSEN. Mr. Chairman, could I be excused to catch an airplane, please?

Mr. GIBBONS [presiding]. Yes, sir. But before you do, let me ask you a question. The staff would like to submit or some of the members would like to submit written questions to you that perhaps you could help us understand——

Mr. JENSEN. I would be more than happy to. The study on the tax revenue estimates, I gave a copy of that to one of the members of the staff, but I would be more than happy to answer any questions that you might have.

Mr. GIBBONS. Thank you very much.

Mr. MOODY. Can I ask, Mr. Jensen, do you have a minute?

Mr. JENSEN. Sure.

Mr. MOODY. Mr. Chairman, if I could have a second.

Mr. GIBBONS. Sure, go ahead. It is up to Mr. Jensen.

Mr. MOODY. Thank you. I will not hold you long.

You said that one of the goals of the suggestions you made was to get out trapped equity.

Mr. JENSEN. Yes.

Mr. MOODY. What is the public policy reasoning for "getting out trapped equity?" I mean, you are not increasing the total capital supply that way. Are you not moving it from one form of capital to another?

Mr. JENSEN. You are moving it from a place where it is not productive, in fact, having negative productivity effects, to places where it can be very productive. That is, I believe, one of the major problems that we faced with the decline in productivity of——

Mr. MOODY. So it is a capital allocation question.

Mr. JENSEN. Yes, that is exactly right.

Mr. MOODY. Now you are not suggesting we increase the total savings rate or anything like that by this, are you?

Mr. JENSEN. I do not think that would be bad, but we can do much more for improving the competitiveness and productivity in this country in the short run by resolving this incredible waste of capital resources, real resources.

Mr. MOODY. So by allowing established firms with high credit ratings to let that capital flow from equity into debt, how is the capital going to get into the high risk, productive firms?

Mr. JENSEN. The way it is getting out now is through stock repurchases, both of my own firm or somebody else's firm, as Professor Andrews points out, through leveraged recapitalizations, through leveraged buyouts. If you sort of trace what has been going on to the payout from the corporate sector in nondividend forms as well as dividend forms, you can see—because of the fungibility of funds you cannot really trace it exactly, but you can see that there has been a coincident massive increase in the capital in the venture capital business and capital available in the venture capital market. I do not have any doubt that this is having a substantial degree increase in——

Mr. MOODY. But if the capital is going into venture capital which we all want to see happen, where is it coming from?

Mr. JENSEN. It is coming out of organizations like Phillips Petroleum, Gulf Oil.

Mr. MOODY. So they just need less capital?

Mr. JENSEN. Yes, absolutely.

Mr. MOODY. They are just too capital heavy?

Mr. JENSEN. Absolutely; vastly overcapitalized.

Mr. MOODY. So they should downsize their capital?

Mr. **Jensen**. That is exactly right. And that has been happening. The same thing is true in the tobacco business. The tobacco business generates huge amounts of excess cash.

Mr. **Moody**. Even though the earnings at the margin are higher in this venture capital, those differential earnings are not pulling the capital out of——

Mr. **Jensen**. That is right, because the CEO's and the managers in those organizations do not want to give it up. They get paid in a way that is related to the size of their organization, and they will not give it up.

Mr. **Moody**. Not rate of return on equity. That is not their——

Mr. **Jensen**. That is exactly right. That is exactly right.

Mr. **Moody**. They are paid by scale rather than by rate of return.

Mr. **Jensen**. Unfortunately, that is true.

Mr. **Moody**. I do not want to hold you any longer. I have a question or two for the others.

Mr. **Jensen**. Thank you very much, and I apologize for leaving.

Mr. **Gibbons**. Thank you.

Let me ask the whole panel a question. Are any of you in favor of limiting foreign investment in the United States?

Mr. **Auerbach**. Limiting foreign investment?

Mr. **Gibbons**. Limiting foreign investment in the United States. Do you think it is a problem? Other than a psychological problem?

Mr. **Auerbach**. I think it reflects other problems, having to do with the—in and of itself?

Mr. **Gibbons**. In and of itself?

Mr. **Auerbach**. I do not believe so, no.

Mr. **Warren**. I would agree with that.

Mr. **Ribstein**. No, I am not in favor of that.

Mr. **Gibbons**. Fine. I do not think we have any more questions. Go ahead, Mr. Moody.

Mr. **Moody**. Do any of the three of you think that the greater and greater leveraging of businesses we see through this process, and I guess all of you agree the debt equity ratio has been steadily altering, increases the fragility of this system at all in terms of facing business cycles that inevitably do come?

Is that an element in your calculations here, or do you think that is a nonissue? We have had some very eminent people here, like Marty Feldstein, say yes, it does increase the fragility of the system, but we do not know how much. Do you think this should weigh in our calculations?

Mr. **Auerbach**. It certainly, to some extent, must increase the fragility because it increases the probability that in the next credit crunch or recession some companies will go under. If those probabilities, increased probability of default, and the costs that will ensue are being taken into account by the companies that borrow and the lenders that lend to them, I do not see that as a social problem.

If that is being further encouraged by the relative tax advantage of debt, then it has become a social problem because of that, and I think that there is a straightforward, although not necessarily easy, solution to that, which is to reduce the relative tax advantage of borrowing.

If the question is, is there beyond that, beyond the tax advantage of debt, is there a social cost to additional borrowing that is not taken into account by those that borrow, it is certainly possible but I do not know that there is any evidence to support that and I would argue against enacting any policy to counteract this perceived problem.

Mr. MOODY. In other words, you are saying the fragility increase would probably be capitalized into the asset values or into the rates of return required.

Mr. AUERBACH. Right.

Mr. MOODY. You do not see an externality to bankruptcy then, beyond the parties involved?

Mr. AUERBACH. Given the levels of debt that currently prevail, I do not see why one should think that would be the case. These are not unprecedented ratios for the U.S. They are lower than ratios that one observes in other countries. Yes, bankruptcies are going to occur, but the issue is if this is going to set in motion the collapse of the financial sector or collapse of manufacturing, I do not see that as a likely outcome.

Mr. RIBSTEIN. Congressman, if I might add something.

Mr. MOODY. Please. The reason I ask is that Professor Friedman was sitting here yesterday in your spot saying, he is very concerned about the increased leveraging in the corporate sector, not in the household sector, but in the corporate sector, because there are synergistic effects of collapses and there is a certain chain reaction effect which is not captured in the individual market agreements that are set up leading, prior to this. That is the point.

Mr. AUERBACH. One point that, knowing Professor Friedman's arguments, I think he would have made, and I do not subscribe to and there would be additional costs, would be that somehow once this debt is on the balance sheets of corporations, it will tie the hands of the Federal Reserve, in terms of its conduct of monetary policies.

If the Fed sees that raising interest rates is going to drive the country into a very serious recession with lots of bankruptcies, that might make it less willing to adopt what it sees as the appropriate monetary policy.

Mr. MOODY. It does reduce its flexibility in monitoring policy?

Mr. AUERBACH. Right.

Mr. MOODY. Responding to changing the dollar value or whatever, inflation?

Mr. AUERBACH. Right. But it is also true that the Fed has, in the past, found it possible to help us go into recessions in which we experienced unemployment rates over 10 percent. I do not know how the people at the Fed make their calculations, but if they think that bringing down the inflation rate and having a sound dollar and so forth is worth a 10 percent unemployment rate, I would imagine that they would also think a few bankruptcies would be in the cards, as well.

Mr. MOODY. I am sorry to interrupt. Go ahead, sir.

Mr. RIBSTEIN. I think that there are two issues here. One is whether we need to worry about any fragility that is occurring, and I think that was the point Mr. Auerbach was responding to. But I am not at all convinced that there is increased fragility to the extent that leveraged buyouts make managers more careful about what they do, getting involved in projects and so forth, decreasing costs and so forth.

You are talking about turning companies not only into more productive enterprises, but into companies that may be more able to withstand downturns.

Mr. MOODY. More resilient.

Mr. RIBSTEIN. That is right. Overweight companies are going to be the first to collapse and die in a downturn, and that is what we are getting away from, is overweight companies.

Mr. MOODY. Are these anatomical metaphors appropriate? If we are talking about going on a diet, let us say, fat cells might be helpful.

Mr. RIBSTEIN. LBO's do lower cholesterol. [Laughter.]

Mr. MOODY. But they are highly leveraged and that is a fixed cost now to business. Before, equity payments were not a fixed cost. Now you have got a larger fixed cost component on your cost side, and if you run into a downturn, you may find yourself in danger. Sure, they may be leaner and meaner, cholesterol has been reduced, but they have a higher fixed variable rate cost component.

Mr. RIBSTEIN. All I am saying is, while I think you are absolutely right, of course, I think it is a mistake to focus just on that factor.

Mr. MOODY. A final question for me would be regarding the neutrality argument that all of you make, and a number of others have made here. Do all of the three of you agree that we should move to a differential tax on long-term capital gains?

Mr. WARREN. I would not.

Mr. MOODY. You would not. Mr. Auerbach?

Mr. AUERBACH. In isolation, I would not either.

Mr. MOODY. In connection with a "neutrality" move on dividends? For example, Henry Kaufman was here earlier today. His first two points were to neutralize the tax treatment of dividends and interest payments, and to change the capital gains rate. He sees them as a tandem pair.

Mr. AUERBACH. I think if the tax rate on dividends is being reduced, there is an argument also for reducing the effective rate of capital gains taxation.

Mr. MOODY. But is this not a way of hiding gains without deferring taxes indefinitely?

Mr. AUERBACH. The point is there would be less of an incentive for the gains to be hidden and deferred if the dividend tax rate were reduced. In some sense, one of the arguments in favor of maintaining a capital gains tax is that it protects the Treasury from funds being retained in corporations and not being paid out as dividends.

To the extent that that incentive is removed and dividends are taxed less heavily, the arguments in favor of maintaining the current level of capital gains tax go down as well, I think. I think there are many other arguments, too, but I think one can argue more strongly in favor——

Mr. MOODY. So it is an unlocking device.

Mr. AUERBACH. The capital gains tax, in some sense, is a barrier to ways out of the dividend tax. If the dividend tax is reduced or removed, then no such barrier is necessary.

Mr. Moody. So lowering the tax on dividends liquifies the process, allows the earnings to be paid out, unlocks that capital. On the other hand, having a long-term capital gains differential tends to lock in capital until that date has arrived. Professor Warren, you would favor neutralizing the dividend treatment, but without a capital gains differential?

Mr. Warren. It depends on what we mean by neutralizing the dividend treatment. If you are talking about reducing shareholder tax rates on dividends, then I would think the capital gains rate should go down, also. But if what we are talking about is integration, giving shareholders a shareholder credit for corporate taxes paid with respect to dividends, then I would think that you would want to keep an equivalence between the dividend tax rate and the capital gains rate, because otherwise you are going to be back to encouraging the kinds of transactions we are talking about today, where you create financial transactions to get money out of corporations at capital gains rates through share purchasers or LBO's, rather than through dividends.

What I would say, and I am not sure this is inconsistent with what Alan was saying, is that the dividend rate and the capital gains rate should be linked in an integrated system.

Mr. Moody. Does the progressivity impact of reducing the taxation of dividends bother you? If we are talking about a $30 billion windfall, let us say, per annum, or at least at the front end. That is not going to go to your average guy with the lunch pail. It is going to go to people who hold capital assets, which are far more skewed than income in America.

Does the regressivity of that move bother any of you?

Mr. Auerbach. You are talking about a program which, in itself, would lose a lot of revenue and I suppose it would matter a lot how the revenue was made up.

Mr. Moody. Suppose it was made up in a distributively neutral way, so that the net effect of the loss in revenue and the recovery of revenue were regressive, because of this feature that we were discussing.

Mr. Auerbach. So that it would not offset the distributional——

Mr. Moody. You would not have a progressive recapture of the revenue. You have a distributively neutral recapture.

Mr. Auerbach. Speaking personally, I think that would disturb me.

Mr. Moody. Would?

Mr. Auerbach. Yes.

Mr. Warren. I agree with that. It seems to me the way to think about this is to ask is it going to be the distributional impact of raising the revenue to fund the decrease in double taxation of dividends.

Mr. Moody. So you would be more comfortable, for example, if we went to the neutral treatment as we offset the revenue effects of that by some other device which would be progressive in its collection? Is that accurate?

Mr. Warren. If it would be comparable in its impact, yes.

Mr. Moody. To restore the progressivity that exists, whatever does exist. Thank you very much.

Chairman **Rostenkowski**. Gentlemen, thank you very much for joining us. I hope to feel free that if I want to call you and talk with you, or any member of the committee wants to sit down and talk with you, that we can do that. Thanks a lot.

[The following questions from Congressman Coyne and responses from Dr. Auerbach were subsequently received:]

Q: In your 1986 paper on taxation and merger decisions, you said that some mergers "are associated with private gains that may very well be more than offset by the losses of others in society." Do you believe that it is economically desirable for the federal government to discourage or prohibit mergers of this sort -- that is, mergers that are not found to be in the public interest?

A: Yes, I do believe that mergers of this sort should be discouraged by the federal government. Indeed, the motivation to merge in order to obtain tax benefits at the general taxpayer's expense was sharply restricted by the Tax Reform Act of 1986. To the extent that tax benefits still encourage mergers and acquisitions, such activity should be discouraged further. However, there are different ways to achieve this end. One could restrict mergers and acquisitions directly, or instead correct the defects in the tax system that introduced the undesirable incentives in the first place. As I indicated in my testimony, I favor the latter course because a more rational tax policy has benefits beyond a more neutral treatment of takeover activity.

Private gains from takeovers at social expense may result from other factors as well, such as reduced competition in product markets. Here, I believe a vigorous antitrust policy rather than new tax policy is appropriate.

Q: Do you know of any way to determine a priori which mergers are good for society and which are not?

A: In some cases, it is possible to identify mergers that are likely to be harmful; for example, a merger that would increase an industry's concentration considerably, or one in which an empty shell with tax benefits were purchased with no obvious business objective beyond the reduction of taxes. Mergers of each type are already severely restricted by antitrust and tax laws.

The more subtle factors that determine whether a merger is successful are much easier to identify after the fact, when an observer can analyze why things went right or why they didn't. Beyond restrictions currently in place, however, it would be difficult to construct accurate, administrable tests to separate the good mergers from the bad.

Q: Would you support legislation or regulatory rules that provided for a review of proposed mergers to determine if they are in the public interest?

A: Such review already occurs with respect to antitrust issues. Tax issues have been and are now being dealt with through legislation. I am not sure what further elements of "the public interest" are contemplated by the question. If, for example, the issue is one of potential layoffs and plant closings, this would be an appropriate concern in all such cases of labor dislocation, not just those associated with mergers. It is not clear to me that there are potential social problems associated with mergers per se that are not already being addressed through the review process and the tax law. I cannot support the institution of an additional review process without a better idea of what this step would be aimed at achieving.

[Whereupon, at 4:45 p.m., the committee was adjourned, to reconvene at 10 a.m., Thursday, February 2, 1989.]

TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

THURSDAY, FEBRUARY 2, 1989

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. This morning the Ways and Means Committee begins its 3d day of hearings on LBO and other corporate transactions that result in equity being replaced by debt.

The testimony we have received in the last 2 days has provided us with a great understanding of the tax and economic issues we must grapple with and great appreciation for the complexity.

I want to thank all of our witnesses for the time they have spent preparing statements for the record and the comprehensive nature of their testimony before us. Also, I wish to commend the members of the committee. Sophistication of the discussions we have had with witnesses shows that you have done your homework preparing for these hearings.

Today we will have an opportunity to receive testimony from another respected group of governmental policymakers, practitioners, other experts and representatives of varied interests. We will begin this morning with Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System. I am not sure where these 3 days of hearings will lead us.

In addition, we plan to hold further hearings on this issue in March. I know that it will take us some time to review and to consider all of the testimony we have received before we determine if legislative changes are necessary and what form they might take. But it is clear that if and when the committee acts, it will do so with great understanding of these issues. Thanks to our witnesses and the work they have put into this hearing.

Our first witness, Mr. Alan Greenspan, has had the opportunity to testify before us several times in the past. Mr. Greenspan, although I will sometimes disagree with your recommendations, I have always respected your opinions, which are based upon great thoughtfulness and sincerity. I am very pleased that you are Chairman of the Federal Reserve, and I feel confident that you can significantly assist this country in these uncertain economic times.

I look forward to hearing your thoughts this morning on this issue of corporate debt as well as the budget deficit and the economy. Please proceed, Mr. Chairman.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. Greenspan. Thank you very much, Mr. Chairman.

Let me say I very much appreciate those kind introductory remarks.

I would like to excerpt from my written copy and ask that the full transcript be included in the record.

Chairman Rostenkowski. Mr. Chairman, your entire statement will be included in the record, and you may proceed whichever way you would like.

Mr. Greenspan. I am pleased to be here today to discuss corporate restructuring and the need for reducing the Federal budget deficit, issues raised in your letter of invitation.

The spate of mergers, acquisitions, leveraged buyouts and divestitures in recent years has major implications for the American economy. While the evidence suggests that the restructurings of the 1980's probably are improving, on balance, the efficiency of our economy, the worrisome and possibly excessive degree of leveraging associated with this process could create problems for the financial system.

To fashion an appropriate policy response, if any, to this extraordinary restructuring LBO phenomenon, there are some key questions that must be answered. What is behind the corporate restructuring movement? Why is it occurring now in the middle and late 1980's rather than at some earlier time? Why has it involved such a broad leveraging of corporate balance sheets? And, finally, has it been good or bad for the American economy?

The 1980's has been a period of dramatic economic changes: Large swings in the exchange value of the dollar with substantial consequences for trade dependent industries, rapid technological progress, especially in automation and telecommunications, rapid growth in the service sector and large movements in real interest rates and relative prices. Clearly, such changes in the economic environment imply major, perhaps unprecedented, shifts in the optimal mix of assets at firms, owing to corresponding shifts in synergies and new opportunities for improving efficiency.

Some activities need to be shed or curtailed, and others added to or beefed up. Moreover, the long period of slow productivity growth in the 1970's may have partly exacerbated the buildup of a backlog of inefficient corporate practices.

When assets become misaligned or less than optimally managed, there is clearly an increasing opportunity to create economic value by restructuring companies, restoring what markets perceive as a more optimal mix of assets. But restructuring requires corporate control and it shouldn't be a surprise that in recent years unaffiliated corporate restructurers or "corporate raiders" have significantly bid up the control premiums over the passive investment value of companies that are deemed to have suboptimal asset allocations.

Observed stock prices do not always reflect values of shares as passive investments, but there can be for any individual company two or more prices for its shares reflecting the degree of control over a company's mix of assets.

Tender offer premiums, which represent the price that active investors are willing to pay for corporate control, ranged from 13 to 25 percent in the 1960's, but have moved to 45 percent and higher during the past decade, underscoring the evident increase in the perceived profit to be gained from corporate control and restructuring.

Interest in restructuring also has been spurred by the increased willingness and ability of corporate managers and owners to leverage balance sheets. The gradual replacement of managers who grew up in the Depression and developed a strong aversion to bankruptcy risks probably accounts for some of the increased proclivity to issue debt now.

Moreover, innovations in capital markets have made the increased propensity to leverage feasible. It is now, for example, much easier than it used to be to mobilize tremendous sums of debt capital for leveraged purchases of firms. The phenomenal development for the market for low-grade corporate debt, that is "junk" bonds, has enhanced the availability of credit for a wide variety of corporate transactions.

The tax benefits of restructuring activities are, of course, undeniable, but this is not a particularly new phenomenon. Our tax system has long favored debt finance by taxing the earnings of corporate debt capital only at the investor level while earnings on equity capital are taxed at both the investor and corporate level.

Evidence about the economic consequences of restructuring is beginning to take shape, but much remains conjectural. It is clear that the markets believe that the recent restructurings are potentially advantageous. Estimates range from $200 billion to $500 billion or more in gains to shareholders since 1982. These gains are reflections of the expectations of market participants, that the restructurings will in fact lead to a better mix of assets with companies and greater efficiencies in their use. This, in turn, is expected to produce marked increases in future productivity and hence in the value of American corporate business.

Many of the internal adjustments brought about by changes in management or managerial policies are still being implemented, and it will take time before they show up for good or ill in measures of performance. So far various pieces of evidence indicate that the trend toward more ownership by managers and tighter control by owners and creditors has generally enhanced operational efficiency.

In the process, both jobs and capital spending in many firms have contracted as unprofitable projects are scrapped. But no clear trends in these variables are yet evident in restructured firms as a group. For the business sector generally, of course, growth of both employment and investment has been strong.

If what I have outlined this morning is a generally accurate description of the causes of the surge in restructurings of the past decade, one would assume that a stabilization of interest rates, exchange rates, and product prices would slow the emergence of newly misaligned companies and opportunities for further restructuring. Such a development would presumably lower control premiums and reduce the pace of merger, acquisition, and LBO activity.

This suggests the most potent policies for diffusing the restructuring over the long-haul are essentially the same macroeconomic policies toward budget deficit reduction and price stability that have been the principal policy concerns of recent years.

Whatever the trends in restructuring, we cannot ignore the implications of the associated heavy leveraging for broad-based risks in the economy. Other things equal, greater use of debt makes the corporate sector more vulnerable to an economic downturn or a rise in interest rates. The financial stability of lenders, in turn, also may be affected. Lenders to leveraged enterprises have been in large part those that can most easily absorb losses without major systemic consequences. They include mutual funds, pension funds, and insurance companies, which generally have diversified portfolios and have traditionally invested in securities involving some risk, such as equities.

To the extent that such debt is held by individual institutions that are not well diversified, there is, of course, some concern. At the Federal Reserve, we are particularly concerned about the increasing share of restructuring loans made by banks. Massive failures of these loans could have broad ramifications. We must resist, however, the temptation to seek to allocate credit to specific users through the tax system or through the regulation of financial institutions.

Restrictions on the deductibility of interest unavoidably involve an important element of arbitrariness, one that will affect not only those kinds of lending intended, but other types as well. Moreover, foreign acquirers could be given an artificial edge to the extent that they could avoid these restrictions. Also, the historical experiences with various types of selective credit controls clearly indicates that in time borrowers and lenders find ways around them.

All that doesn't mean that we should do nothing. The double taxation of earnings from corporate equity capital has added to leveraging, and thus debt levels are higher than they need or should be.

Unfortunately, our options for dealing with this distortion are severely constrained by the Federal Government's serious budget deficit problems, a matter that I will turn to in a moment.

One straightforward approach to this distortion, of course, would be a substantial reduction in the corporate income tax. Alternatively, partial integration of corporate and individual income taxes could be achieved by allowing corporations a deduction for dividends paid or by giving individuals credit for taxes paid at the corporate level. But these changes taken alone will result in a substantial revenue loss. An estimate of IRS collections from taxing dividends is in the range of $20 to $25 billion annually.

Dangers of risk to the banking system associated with high debt levels also warrant attention. As I have noted, the Federal Reserve in its role as a supervisor of banks has particular concerns in this regard. In 1984, the Board issued supervisory guidelines for assessing LBO-related loans, which are set forth in an attachment to my text.

These guidelines emphasize that the circumstances associated with highly leveraged deals require that creditors exercise credit judgment with special care, assessing those risks that are firm specific, as well as those common to all highly-leveraged firms. The Federal Reserve is currently reviewing guidelines for evaluating bank participation in highly leveraged financing transactions. We anticipate that this review will be completed shortly.

I would like to take a few minutes in addition this morning to concentrate on the budget deficit and the corrosive impact it is having on the economy. It is beguiling to contemplate the strong economy of recent years in the context of very large deficits and to conclude that the concerns about the adverse effects of the deficit on the economy have been misplaced. But this argument is fanciful.

The deficit already has begun to eat away at the foundations of our economic strength. And the need to deal with it is becoming ever more urgent. To the extent that some of the negative effects of deficits have not as yet been felt, they have been merely postponed, not avoided.

The damage to the economy occurs because deficits tend to pull resources away from net private investment, reducing the growth of the Nation's capital stock. This, in turn, has meant less capital per worker than would otherwise have been the case, and this will surely engender a shortfall in labor productivity growth, and with it a shortfall in growth of standards of living. Not surprisingly, we have already experienced a disturbing decline in the level of net investment as a share of GNP. Net investment has fallen to 4.7 percent of GNP in the 1980's from an average level of 6.7 percent in the 1970's, and even higher in the earlier decades. Moreover, it is not only by our own historic standards, but by international standards as well.

It is important to recognize that the negative effects of Federal deficits on growth in the capital stock may be attenuated for a while by several forces in the private economy. One is a long period of output growth in excess of potential GNP growth, such as occurred over much of the past 6 years, which undoubtedly boosts sales and profit expectations and hence business investment. Such rates of output cannot persist, making this factor inherently temporary in nature.

Finally, net inflows of foreign savings can be, as in recent years, an important addition to savings. In the 1980s, our ability to tap foreign savings has kept the decline in the gross investment/GNP ratio on average to only moderate dimensions.

But, the continuation of inflows of foreign savings at current levels is clearly questionable. Domestic investment tends to be supported by domestic savings alone in the long run.

Let me conclude, Mr. Chairman, by reiterating that the budget deficit must be brought down. I do not underestimate the difficult decisions that you must make if we are to achieve the necessary reduction in the deficit in the years ahead, but allowing deficits to persist courts a dangerous corrosion of our economy and risks potentially significant reductions over time in our standard of living.

Thank you very much.

[The statement of Alan Greenspan follows:]

Statement by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

Mr. Chairman and other members of the Ways and Means Committee, I am pleased to be here today to discuss corporate restructuring and the need for reducing the federal budget deficit, issues raised in your letter of invitation.

Corporate Restructuring and Leveraging

The spate of mergers, acquisitions, leveraged buyouts, share repurchases, and divestitures in recent years has major implications for the American economy. While the evidence suggests that the restructurings of the 1980s probably are improving, on balance, the efficiency of our economy, the worrisome and possibly excessive degree of leveraging associated with this process could create a set of new problems for the financial system.

Corporate restructuring is not new to American business. It has long been a feature of our enterprise system, a means by which firms adjust to ever-changing product and resource markets, and to perceived opportunities for gains from changes in management and management strategies.

However, the 1980s have been characterized by features not present in previous episodes. The recent period has been marked not only by acquisitions and mergers, but also by significant increases in leveraged buyouts, divestitures, asset sales, and share repurchase programs. In many cases, recent activity reflects the break-up of the big conglomerate deals packaged in the 1960s and 1970s. Also, the recent period has been characterized by the retirement of substantial amounts of equity (more than $500 billion since 1983) mostly financed by borrowing in the credit markets.

The accompanying increase in debt has resulted in an appreciable rise in leverage ratios for many of our large corporations. Aggregate book value debt-equity ratios, based on balance sheet data for nonfinancial firms, have increased sharply in the 1980s, moving outside their range in recent decades, although measures based on market values have risen more modestly.

Alonu with this debt expansion, the ability of firms in the aggregate to cover interest payments has deteriorated. The ratio of gross interest payments to corporate cash flow before interest provision is currently around 35 percent, close to the 1982 peak when interest rates were much higher and profits were weak owing to the recession. Lately, profits have been fairly buoyant; the current deterioration has been due to heavier debt burdens.

A measure of credit quality erosion is suggested by an unusually large number of downgradings of corporate bonds in recent years. The average bond rating of a large sample of firms has declined fairly significantly since the late 1970s, from A+ to A-.

To fashion an appropriate policy response, if any, to this extraordinary restructuring/LBO phenomenon, there are some key questions that must be answered: What is behind the corporate restructuring movement? Why is it occurring now, in the middle and late 1980s, rather than in some earlier time? Why has it involved such a broad leveraging of corporate balance sheets? And finally, has it been good or bad for the American economy?

The 1980s has been a period of dramatic economic changes: large swings in the exchange value of the dollar, with substantial consequences for trade-dependent industries; rapid technological progress, especially in automation and telecommunications; rapid growth in the service sector; and large movements in real interest rates and relative prices. Clearly, such changes in the economic environment imply major, perhaps unprecedented, shifts in the optimal mix of assets at firms--owing to corresponding shifts in synergies--and new opportunities for improving efficiency. Some activities need to be shed or curtailed, and others added or beefed up. Moreover, the long period of slow productivity growth in the 1970s may have partly exacerbated the buildup of a backlog of inefficient corporate practices.

When assets become misaligned or less than optimally managed, there is clearly an increasing opportunity to create economic value by restructuring companies, restoring what markets perceive as a more optimal mix of assets. But restructuring requires corporate control. And managers, unfortunately, often have been slow in reacting to changes in their external environment, some more so than others. Hence, it shouldn't be a surprise that, in recent years, unaffiliated corporate restructurers, some call them corporate raiders, have significantly bid up the control premiums over the passive investment value of companies that are perceived to have suboptimal asset allocations. If a company has an optimal mix and is appropriately managed, there is no economic value to be gained from restructuring and, hence, no advantage in obtaining control of a company for such purposes. In that case, there is no incentive to bid up the stock price above the passive investment value based on its existing, presumed optimal, mix of assets. But in an economy knocked partially off kilter by real interest rate increases and gyrations in foreign exchange and commodity prices, there emerge significant opportunities for value-creating restructuring at many companies.

This presumably explains why common stock tender offer prices of potential candidates for restructuring have risen significantly during the past decade. Observed stock prices generally (though not always) reflect values of shares as passive investments. But there can be, for any individual company, two or more prices for its shares, reflecting the degree of control over a company's mix of assets.

Tender-offer premiums--which represent the price that active investors are willing to pay for corporate control--ranged from 13 to 25 percent in the 1960s, but have moved to 45 percent and higher during the past decade, underscoring the evident increase in the perceived profit to be gained from corporate control and restructuring.

Interest in restructuring also has been spurred by the apparent increased willingness and ability of corporate managers and owners to leverage balance sheets. The gradual replacement of managers who grew up in the Depression and developed a strong aversion to bankruptcy risk probably accounts for some of the increased proclivity to issue debt now.

Moreover, innovations in capital markets have made the increased propensity to leverage feasible. It is now much easier than it used to be to mobilize tremendous sums of debt capital for leveraged purchases of firms. Improvements in the loan-sale market among banks and the greater presence of foreign banks in U.S. markets have greatly increased the ability of the banking sector to participate in merger and acquisition transactions. The phenomenal development of the market for low-grade corporate debt, so-called "junk bonds," also has enhanced the availability of credit for a wide variety of corporate transactions. The increased liquidity of this market has made it possible for investors to diversify away firm-specific risks by building portfolios of such debt.

The tax benefits of restructuring activities are, of course, undeniable, but this is not a particularly new phenomenon. Our tax system has long favored debt finance by taxing the earnings of corporate debt capital only at the investor level, while earnings on equity capital are taxed at both the investor and corporate levels. There have been other sources of tax savings in mergers that do not depend on debt finance, involving such items as the tax basis for depreciation and foreign tax credits. And taxable owners benefit when firms repurchase their own shares, using what is, in effect, a tax-favored method of paying cash dividends. In any event, the recent rise in restructuring activity is not easily tied to any change in tax law.

Evidence about the economic consequences of restructuring is beginning to take shape, but much remains conjectural. It is clear that the markets believe that the recent restructurings are potentially advantageous. Estimates range from $200 billion to $500 billion or more in paper gains to shareholders since 1982. Apparently, only a small portion of that has come at the expense of bondholders. These gains are reflections of the expectations of market participants that the restructuring will, in fact, lead to a better mix of assets within companies and greater efficiencies in their use. This, in turn, is expected to produce marked increases in future productivity and, hence, in the value of American corporate business. Many of the internal adjustments brought about by changes in management or managerial policies are still being implemented, and it will take time before they show up for good or ill in measures of performance.

So far, various pieces of evidence indicate that the trend toward more ownership by managers and tighter control by other owners and creditors has generally enhanced operational efficiency. In the process, both jobs and capital spending in many firms have contracted as unprofitable projects are scrapped. But no clear trends in these variables are yet evident in restructured firms as a group. For the business sector, generally, growth of both employment and investment has been strong.

If what I've outlined earlier is a generally accurate description of the causes of the surge in restructurings of the past decade, one would assume that a stabilization of interest rates, exchange rates, and product prices would slow the emergence of newly misaligned companies and opportunities for further restructuring. Such a development would presumably lower control premiums and reduce the pace of merger, acquisition, and LBO activity.

This suggests that the most potent policies for defusing the restructuring/LBO boom over the long haul are essentially the same macroeconomic policies toward budget deficit reduction and price stability that have been the principal policy concerns of recent years.

Whatever the trends in restructuring, we cannot ignore the implications of the associated heavy leveraging for broad-based risk in the economy. Other things equal, greater use of debt makes the corporate sector more vulnerable to an economic downturn or a rise in interest rates. The financial stability of lenders, in turn, also may be affected. How much is another question. The answer depends greatly on which firms are leveraging, which financial institutions are lending, and how the financings are structured.

Most of the restructured firms appear to be in mature, stable, non-cyclical industries. Restructuring activity has been especially prevalent in the trade, services, and, more recently, the food and tobacco industries. For such businesses, a substantial increase in debt may raise the probability of insolvency by only a relatively small amount. However, roughly two-fifths of merger and aquisition activity, as well as LBOs, have involved companies in cyclically sensitive industries that are more likely to run into trouble in the event of a severe economic downturn.

Lenders to leveraged enterprises have been, in large part, those that can most easily absorb losses without major systemic consequences. They include mutual funds, pension funds, and insurance companies, which generally have diversified portfolios and have traditionally invested in securities involving some risk, such as equities. To the extent that such debt is held by individual institutions that are not well diversified, there is some concern. At the Federal Reserve, we are particularly concerned about the increasing share of restructuring loans made by banks. Massive failures of these loans could have broader ramifications.

Generally, we must recognize that the line between equity and debt has become increasingly fuzzy in recent years. Convertible debt has always had an intermediate character, but now there is almost a continuum of securities varying in their relative proportions of debt and equity flavoring. Once there was a fairly sharp distinction between being unable to make interest payments on a bond, which frequently led to liquidation proceedings, and merely missing a dividend. Now the distinction is smaller. Outright defaults on original issue high-yield bonds have been infrequent to date, but payment difficulties have led to more frequent exchanges of debt that reduce the immediate cash needs of troubled firms. Investors know when they purchase such issues that the stream of payments received may well differ from the stream promised, and prices tend to move in response to changes in both debt and equity markets. In effect, the yields on debt capital rise toward that of equity capital when scheduled repayments are less secure.

In view of these considerations, and the very limited evidence on the effects of restructuring at the present time, it would be unwise to restrict arbitrarily corporate restructuring. We must resist the temptation to seek to allocate credit to specific uses through the tax system or through the regulation of financial institutions. Restrictions on the deductibility of interest unavoidably involve an important element of arbitrariness, one that will affect not only those types of lending intended but other types as well. Moreover, foreign acquirers could be given an artificial edge to the extent that they could avoid these restrictions. Also, the historical experience with various types of selective credit controls clearly indicates that, in time, borrowers and lenders find ways around them.

All that doesn't mean that we should do nothing. The contribution of our tax structure to corporate leveraging warrants attention. The double taxation of earnings from corporate equity capital has added to leveraging, and thus debt levels are higher than they need, or should, be. Our options for dealing with this distortion are, unfortunately, constrained severely by the federal government's still serious budget deficit problems, a matter that I will turn to in a moment. One straightforward approach to this distortion, of course, would be to substantially reduce the corporate income tax. Alternatively, partial integration of corporate and individual income taxes could be achieved by allowing corporations a deduction for dividends paid or by giving individuals credit for taxes paid at the corporate level. But these changes taken alone would result in substantial revenue losses; a rough estimate of IRS collections from taxing dividends is in the range of $20 to $25 billion annually.

Dangers of risk to the banking system associated with high debt levels also warrant attention. As I have noted, the Federal Reserve, in its role as a supervisor of banks, has particular concerns in this regard. In 1984, the Board issued supervisory guidelines for assessing LBO-related loans, which are set forth in an attachment to my text. These guidelines emphasized that the circumstances associated with highly leveraged deals require that creditors exercise credit judgment with special care, assessing those risks that are firm-specific as well as those common to all highly leveraged firms. The Federal Reserve is currently in the process of reviewing guidelines regarding the evaluation of bank participation in highly leveraged financing transactions; we anticipate that this review will be completed shortly.

The Budget Deficit and the Economy

The remainder of my prepared remarks will concentrate on the budget deficit and the corrosive impact it is having on the economy.

It is beguiling to contemplate the strong economy of recent years in the context of very large deficits and to conclude that the concerns about the adverse effects of the deficit on the economy have been misplaced. But this argument is fanciful. The deficit already has begun to eat away at the foundations of our economic strength. And the need to deal with it is becoming ever more urgent. To the extent that some of the negative effects of deficits have not as yet been felt, they have been merely postponed, not avoided. Moreover, the scope for further such avoidance is shrinking.

To some degree, the effects of the federal budget deficits over the past several years have been muted by two circumstances, both of which are currently changing rapidly. One was the rather large degree of slack in the economy in the early years of the current expansion. This slack meant that the economy could accommodate growing demands from both the private and public sectors. In addition, to the extent that these demands could not be accommodated from U.S. resources, we went abroad and imported them. This can be seen in our large trade and current account deficits. By now, however, the slack in the U.S. economy has diminished substantially. And as inflows of foreign saving are reduced along with our trade deficit, other sources of saving must be found, or demands for saving curtailed. The choices are limited; as will become clear, the best option for the American people is a further reduction in the federal budget deficit, and the need for such reduction is becoming more pressing.

Owing to significant efforts by the executive branch and the Congress, coupled with strong economic growth, the deficit has shrunk from 5 to 6 percent of gross national product a few years ago to about 3 percent of GNP today. Such a deficit, nevertheless, is still very large by historical standards. Since World War II, the actual budget deficit has exceeded 3 percent of GNP only in the 1975 recession period and in the recent deficit experience beginning in 1982. On a cyclically adjusted or structural basis, the deficit has exceeded 3 percent of potential GNP only in the period since 1983.

Government deficits, however, place pressure on resources and credit markets, only if they are not offset by saving elsewhere in the economy. If the pool of private saving is small, federal deficits and private investment will be in keen competition for funds, and private investment will lose.

The United States deficits of recent years are threatening precisely because they have been occurring in the context of private saving that is low by both historical and international standards. In the 1980s, net personal plus business saving in the United States has been about 3 percentage points lower relative to GNP than its average in the preceding three decades. Internationally, government deficits have been quite common among the major industrial countries in the 1980s, but private saving rates in most of these countries have exceeded the deficits by very comfortable margins. In Japan, for example, less than 20 percent of its private saving has been absorbed by government deficits, even though the Japanese general government has been borrowing almost 3 percent of its gross domestic product in the 1980s. In contrast, over half of private U.S. saving in the 1980s has been absorbed by the combined deficits of the federal and state and local sectors.

Under these circumstances, such large and persistent deficits are slowly but inexorably damaging the economy. The damage occurs because deficits tend to pull resources away from net private investment, which damps the growth of the nation's capital stock. This in turn has meant less capital per worker than would otherwise have been the case, and this will surely engender a shortfall in labor productivity growth and, with it, a shortfall in growth of the standard of living.

All else equal, the higher real interest rates associated with increased borrowing by the Treasury in the 1980s have reduced private investment in the aggregate. Moreover, the higher real interest rates have shifted the composition of investment away from long-lived assets, such as factories, toward computers and other shorter-lived equipment. The data also underscore a recent decline in the average service life of consumption as well as investment goods and a systematic tendency for this average to move inversely with real rates of interest. That is, the higher are real interest rates, the heavier is the concentration on short-lived assets.

Not surprisingly, we have already experienced a disturbing decline in the level of net investment as a share of GNP. Net investment has fallen to 4.7 percent of GNP in the 1980s from an average level of 6.7 percent in the 1970s and even higher in the 1960s. Moreover, it is low, not only by our own historical standards, but by international standards as well.

International comparisons of net investment should be viewed with some caution because of differences in the measurement of depreciation and in other technical details. Nevertheless, the existing data do indicate that total net private and public investment as a share of gross domestic product over the period between 1980 and 1986 was lower in the United States than in any of the other major industrial countries except the United Kingdom.

It is important to recognize as I indicated earlier that the negative effects of federal deficits on growth in the capital stock may be attenuated for a while by several forces in the private sector. One is a significant period of output growth in excess of potential GNP growth--such as occurred over much of the past six years--which undoubtedly boosts sales and profit expectations and, hence, business investment. Such rates of output growth, of course, cannot persist, making this factor inherently temporary in nature.

Another factor tending to limit the decline in investment spending would be any tendency for saving to respond positively to the higher interest rates that deficits would bring. The supply of domestic private saving has some interest elasticity, as people put off spending when borrowing costs are high and returns from their financial assets are favorable. But most analysts find that this elasticity is not sufficiently large to matter much.

Finally, net inflows of foreign saving can be, as recent years have demonstrated, an important addition to saving. In the 1980s, our ability to tap foreign saving has kept the decline in the gross investment-GNP ratio, on average, to only moderate dimensions (slightly more than one-half percentage point) compared with the 1970s, while the federal deficit rose by about 2-1/2 percentage points relative to GNP. Net inflows of foreign saving have amounted, on average, to almost 2 percent of GNP, an unprecedented level.

Looking ahead, the continuation of inflows of foreign saving at current levels is questionable. Evidence for the United States and for most other major industrial nations over the last 100 years indicates that such sizable foreign net capital inflows have not persisted and, hence, may not be a reliable substitute for domestic saving on a long-term basis. In other words, domestic investment tends to be supported by domestic saving alone in the long run.

Let me conclude by reiterating that the budget deficit must be brought down. I do not underestimate the difficult decisions that you must make if we are to achieve the necessary reduction in the deficit. But allowing deficits to persist courts a dangerous corrosion of our economy and risks potentially significant reductions over time in our standard of living.

ATTACHMENT

The Federal Reserve's directive to examiners on leveraged buyout loans, issued in 1984, provided the following supervisory guidance to supplement standard loan review procedures:

> The nature of leveraged buyouts and, in particular, the level of debt typically involved in such arrangements give rise to supervisory concerns over the potential risk implications for bank loan portfolios. The high volume of debt relative to equity that is characteristic of leveraged buyouts leaves little margin for error or cushion to enable the purchased company to withstand unanticipated financial pressures or economic adversity. Two principal financial risks associated with leveraged buyout financing are: (1) the possibility that interest rates may rise higher than anticipated and thereby significantly increase the purchased company's debt service burden; and/or (2) the possibility that the company's earnings and cash flow will decline or fail to meet projections, either because of a general economic recession or because of a downturn in a particular industry or sector of the economy. While either one of these developments can undermine the creditworthiness of any loan, the high degree of leverage and the small equity cushion typical of most leveraged buyouts suggest that economic or financial adversity will have a particularly large and negative impact on such companies. Thus, a leveraged buyout arrangement that appears reasonable at a given rate of interest or expected cash flow can suddenly appear to be questionable if interest rates rise significantly or if earnings should fail to provide an adequate margin of coverage to service the acquisition debt.
>
> In addition to unfavorable interest rate movements and earnings developments, adverse economic conditions may also have a negative impact on the value of a company's collateral. For example, if a general economic slowdown reduces a company's sales and earnings, the marketability and value of its collateral may also suffer. In any event, given the amount of debt involved in leveraged buyouts, the value of collateral is extremely important, and the risk that collateral coverage may be insufficient to protect the bank is a significant factor in evaluating the creditworthiness of these loans. In light of all of these considerations, the quality of a purchased company's management is also extremely important and represents another critical element in the bank's evaluation of leveraged buyouts. This is because such management must oversee both the special financial risks associated with the leveraged buyout form of acquisition financing as well as the normal day-to-day affairs and operations of the purchased company's business.
>
> In the course of on-site examinations, examiners should review a bank's involvement in leveraged buyout financing as well as the loans associated with individual leveraged buyouts. The following general

guidelines are provided to underscore and supplement existing loan review procedures.

1. In evaluating individual loans and credit files, particular attention should be addressed to i) the reasonableness of interest rate assumptions and earnings projections relied upon by the bank in extending the loan; ii) the trend of the borrowing company's and the industry's performance over time and the history and stability of the company's earnings and cash flow, particularly over the most recent business cycle; iii) the relationship between the company's cash flow and debt service requirements and the resulting margin of debt service coverage; and iv) the reliability and stability of collateral values and the adequacy of collateral coverage.

2. In reviewing the performance of individual credits, examiners should attempt to determine if debt service requirements are being covered by cash flow generated by the company's operations or whether the debt service requirements are being met out of the proceeds of additional or ancillary loans from the bank designed to cover interest changes.

3. Policies and procedures pertaining to leveraged buyout financing should be reviewed to ensure that they incorporate prudent and reasonable limits on the total amount and type (by industry) of exposure that the bank can assume through these financing arrangements.

4. The bank's pricing, credit policies, and approval procedures should be reviewed to ensure i) that rates are reasonable in light of the risks involved and ii) that credit standards are not compromised in order to increase market share. Credit standards and internal review and approval standards should reflect the degree of risk and leverage inherent in these transactions.

5. Total loans to finance leveraged buyouts should be treated as a potential concentration of credit and if, in the aggregate, they are sufficiently large in relation to capital, the loans should be listed on the concentrations page in the examination report.

6. Significant deficiencies or risks regarding a bank's leveraged buyout financing should be discussed on page 1 of the examination report and brought to the attention of the board of directors.

Chairman ROSTENKOWSKI. Thank you, Mr. Chairman.

Mr. Chairman, I am concerned with the economic outlook with respect to interest rates. In 1990, the CBO baseline outlays are almost $14 billion higher than the estimates by the administration due to higher interest rate forecasts. The CBO forecast is very close to many private forecasts and the blue chip consensus of business forecasts, while the administration interest rates are considerably lower. The CBO forecasts that the interest rate on 3-month Treasury bills will average 7.9 percent this year and 7.1 percent next year, while the administration's budget assumes that interest rates will average 6.3 percent this year and 5.5. percent next year.

What, Mr. Chairman, do you believe the chances are that interest rates will fall to the levels assumed by the administration this year and next? What are the chances that interest rates, that is 3-month T bills, will fall to 3 percent in 1994 as the administration assumes?

Mr. GREENSPAN. Mr. Chairman, I think it is important to differentiate between the nature of a forecast such as that made by the Reagan administration in its budget and the conventional forecasts made by private economists, and even CBO, when it is looking at its current services budget. Of necessity, the administration, any administration, will assume in its economic forecast that its budget proposals will be enacted fully and expeditiously.

As I have said elsewhere if we do get a very dramatic decline in the budget deficit, then it is credible to forecast that interest rates will decline. The markets will drive them down. I think that the interest rate estimates in the current Reagan budget for 1989 are low. That is, interest rates were higher in the fourth quarter of 1988 than they were forecasting, and that undershoot came into 1989, and it would be very difficult for them to reach their 1989 target.

Nonetheless, I do not think that they are going far overboard in presuming that rates would decline if the deficit followed the path they are suggesting. I don't want to comment on specific differences between the CBO and OMB forecasts, but I think it is important to recognize that at least in the short run the differences in real growth between the OMB forecast and the CBO and other forecasts are really not very large.

I do think that the CBO forecast is probably more likely to prevail and its real-growth numbers are more likely to prevail than OMB's, but I think we are stretching the capability of forecasting to really argue strenuously one way or the other. Although, the current estimate for 1989 by OMB is not the number I would put down, we would only be fractionally different from that. We just cannot forecast as accurately as the difference between, say, CBO on the one hand, which is a little under 3 percent for this year, and OMB, which is 3.5 percent. Anyone who can forecast real growth within one-half of 1 percent a year in advance gets a medal.

Chairman ROSTENKOWSKI. Thank you, Mr. Chairman.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

I think the Nation is indeed fortunate, Mr. Chairman, to have you at the Federal Reserve. Since our chairman has taken the liberty to go outside of the scope of your testimony on LBO's, let me ask whether or not it falls within your jurisdiction to view the investment that this country is making in education and in training of people that ultimately will be absorbed in society to be able to have the type of productivity that is going to be so necessary if indeed we are going to be competitive and we are going to increase the GNP?

I know as an economist, and I know the awesome responsibilities that you have, that sometimes this just looks like a domestic issue that the Congress has to wrestle with. But, I wonder whether you have taken an overview as to what this country has to do to be truly competitive in trade. That is the end of my question.

Mr. GREENSPAN. Well, Congressman, I think you are raising a very important issue. Although we tend to emphasize the close relationship between capital investment on the one hand and productivity on the other, as well as the relationship between productivity and standards of living, education is also very important in the growth process. I must say that I am quite concerned that our educational levels are not where they have to be in order to maintain increased investment in technology.

We are going to need a highly educated work force to run the system in the decade ahead, and anything we can do to enhance our educational capabilities is clearly a major plus for economic growth.

It is, however, a spending priority which must compete with other spending priorities. But whatever can be done for education, especially without money, is very important, and whatever can be done with appropriated funds should be very carefully looked at.

Mr. RANGEL. People are laughing when you say without money, because that seems as though it is the direction the administration is going. They are concerned and have priorities for everything, but without money. But, I will accept that, except what bothers me more than the budget restraints is the fact that I think this administration, as the previous one, truly believes that the educational responsibility is a local and State responsibility, and you as Chairman of the Federal Reserve Board and other people who are concerned with our international posture, you are really saying it is a national responsibility.

I am not talking about the funding, I am talking about the obligation, the philosophy.

Mr. GREENSPAN. Congressman, I certainly agree that education is a crucial issue in the maintenance of economic growth and the stability of our economy.

On the question of how it is financed, that is an issue which I leave to those more knowledgeable on the subject than I. I can only agree that there is an economic dimension to this of a very significant order.

Mr. RANGEL. I see that, Mr. Chairman, it is a contradiction to say that we have a national and international problem in order to be competitive, and we need a well-trained work force, and we are going to leave it to the mayors and Governors how and if it is going to happen. But you have normally been right in the past, and I hope that you are still correct.

Thank you very much.

Mr. GREENSPAN. Thank you.

Chairman **Rostenkowski**. Mrs. Johnson will inquire.

Mrs. **Johnson**. No questions, Mr. Chairman.

Chairman **Rostenkowski**. Mr. McGrath.

[No response.]

Chairman **Rostenkowski**. Mr. Frenzel will inquire.

Mr. **Frenzel**. Thank you, Mr. Chairman, and thank you, Chairman Greenspan, for your testimony on the subject which, as I understand it, carries a multiple instruction to us, the first of which is to not meddle with the deductibility of interest at this point, but rather to seek a solution in relief of the double taxation of dividends; and, second, do something in a hurry about the deficit because that is gumming up everybody's problem.

If this committee were to follow what seems to be an important thought running through Washington, that is nail some of the interest and then trade it off for some of the dividends, would you consider that a violation of your instructions to us?

Mr. **Greenspan**. Well, I certainly don't consider myself giving instructions to the Congress.

Mr. **Frenzel**. Sharing your wisdom with us.

Mr. **Greenspan**. I like that better.

Mr. **Frenzel**. We are going to be degrading the value of your wisdom?

Mr. **Greenspan**. I like that better. I will comment further, however.

The problem that I have with altering the deductibility of interest, which I must say I have given considerable thought to, is it is difficult to do without inducing undesirable secondary consequences. The basic problem that you have is the extraordinary complexity of economic structure and the ability of thoughtful corporate lawyers to restructure organizations and who borrows from whom in a manner which would gradually diminish the effect of reducing the deductibility of interest.

I would much prefer that Tax Code subsidies for corporate restructuring be resolved on the equity side as distinct from the interest side. I think that is likely to have a straightforward effect. It will remove the subsidy for debt and will not produce, as best I can judge, adverse consequences.

Mr. **Frenzel**. Thank you. We do too. We don't know where we get the money in the budget to do it effectively.

May I ask, however, something different, and that is you have a regulation in place already which some people allege would solve the problem, at least—it has to do with the 50-percent margin requirement on borrowed money which relates to acquisition problems.

You and I have corresponded on this matter, and it was the opinion of the Fed that the aggrieved party should go into court and put that regulation to use. The courts don't seem to think that they have status, and I believe the Board has corresponded with the SEC about its interest in enforcing your regulation.

Can you at this time comment, or if you cannot, could you comment for the record at some later time on using regulations that are already in force where they can be used to help mitigate the problem that is before us?

Mr. **Greenspan**. Congressman, it is our view that the margin requirements are ill-suited for this particular use in the sense that only a court can adjudicate the crucial questions of fact to determine whether a particular transaction violates the margin requirements.

We have suggested that the best method of improving compliance with margin requirements is to provide a private right of action which would enable facts to emerge in an appropriate way.

I will, however, add to my comments formally and at least outline for you some of the concerns we have with respect to this problem and how we think it would be best resolved.

[The information follows:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

March 16, 1989

The Honorable Bill Frenzel
House of Representatives
Washington, D.C. 20515

Dear Congressman:

During the hearing before the Ways and Means Committee on February 2, you requested additional information on the enforcement of margin regulations in corporate takeover transactions. I am furnishing the enclosed response to the Committee for inclusion in the record of the hearing.

Please let me know if I can be of further assistance.

Sincerely,

Further Comments of Chairman Greenspan concerning Enforcement of Margin Regulations in Corporate Takeover Transactions.

Under the margin regulations as currently written, the limits on the amount of credit that can be extended apply only where credit used for the purpose of buying margin stock is directly or indirectly secured by margin stock. See 12 C.F.R. 207.3(b). In cases where this kind of credit is directly secured by margin stock, for example, where margin stock is pledged as collateral, determinations about compliance with the margin limits are usually straightforward. When there is an allegation that a particular credit transaction is indirectly secured by margin stock, as is typically the case in contested takeover situations, any judgment as to whether the margin regulations will be violated almost always depends on the specific characteristics of each transaction.

Under the current margin rules, the concept of indirect security includes a wide variety of arrangements between lenders and borrowers where the lender is relying as a practical matter on margin stock as collateral for the credit, even though the lender does not have a conventional security interest in the stock. 12 C.F.R. 207.2(f) & .112(d). Making these kinds of assessments about what lenders are in fact relying on as collateral in a particular case typically requires an examination of the subjective intent of the parties. For example, it may be necessary to review the terms of the financing transaction and the financial condition of the borrower and decide whether a reasonable person would extend credit in such a situation without requiring the pledge of stock to be acquired.

The agencies charged with administrative enforcement of the margin regulations, the Federal Reserve and the SEC, do not always have immediately available the resources needed to conduct this kind of inquiry, which invariably must be undertaken on an expedited basis. Thus, the existing mechanism for administrative enforcement of the margin regulations may not always provide an effective remedy for margin regulation violations in contested corporate acquisitions. The agencies' task is further complicated by the fact that the financing arrangements for these kind of transactions tend to be unique to that transaction, so that the specific characteristics of the lender-borrower relationship have to be delved into in each case. In addition, in many cases, the terms of proposed credit transactions that will finance a tender offer can be changed several times while the tender offer remains open.

Because of these problems, we have for many years advocated that there be a private right of action that would permit affected parties to bring suit directly against lenders, borrowers, or other interested parties to remedy margin regulation violations. This seems to make especially good sense in the takeover area, where the target companies have the incentive and the resources to press for prompt adjudication of margin regulation issues in the courts. Without the availability of such a remedy, there will not be an appropriate mechanism for enforcement of the margin rules in every case.

Mr. **Frenzel**. Thank you very much, Mr. Chairman. My time has expired.

Chairman **Rostenkowski**. Mr. Stark may inquire.

Mr. **Stark**. Thank you, Mr. Chairman.

Welcome, Chairman Greenspan. I would like to also take the liberty of straying a little bit from your prepared text and suggest while many of us are unsure about the effect of LBO's and what the budget growth in the country will or won't be, I think we could all agree that there is about $100 billion staring us in the face in the savings and loan question, and some of us would suggest that maybe the thing to do is to take the approximately 350 S&L institutions that are technically bankrupt, close them, sell the assets as best we can, pay off the depositors or transfer them to healthy institutions and reform the regulatory system and lump it into one that has at least as good a record as your own institution does in regulating financial institutions. We should swallow the cost as fast as we can, recognize that it is a national obligation to pay for it. Doing it more quickly will save us interest, as the sick institutions drive up the rate the rest have to pay.

Could the Feds live with such a system, or would you have an alternate approach to solving that problem?

Mr. **Greenspan**. Well, Mr. Stark, as you well know, the Treasury Department, in conjunction with the Federal Reserve, Office of Management and Budget, Comptroller of the Currency, and the FDIC, has been discussing this issue at some length, and considerable progress has been made toward a sensible set of recommendations.

The Treasury, which clearly has the lead here and is spending a considerable amount of analytical effort to evaluate a wide variety of separate proposals, will shortly be presenting their results to the President, and I would assume because hearings are currently scheduled and the President does have a budget message, that very shortly details of the overall proposals will emerge.

My recollection is the Secretary Brady is scheduled to testify before the Congress in 2 or 3 weeks, and at that point I think a full proposal will be forthcoming.

Mr. **Stark**. Just one more question. After the proposal has been floated, will you be inclined to offer your comments on the proposal?

Mr. **Greenspan**. Yes, I will, Mr. Stark. I am planning to testify shortly thereafter.

Mr. **Stark**. Thank you very much.

Chairman **Rostenkowski**. Mr. Russo.

Mr. **Russo**. Thank you very much.

Mr. Chairman, as someone who sits on the Budget Committee and having listened to four leading economists last week, their scenario foresaw a hard landing should we not act responsibly on the budget. I think one of the critical things we have to confront is economic assumptions. I think it is very important that you set the stage early, what you think your forecasts are, because if we make a mistake, in September we will have to pay for it.

As I understand it, for every point in the percentage of interest we are off, it costs $11 billion. So if the administration is 2 percentage points off and CBO is right, then we're already $22 billion off even though the lender does not have a conventional security interest in the stock. 12 C.F.R. 207.2(f) & .112(d). Making these kinds of assessments about what lenders are in fact relying on as collateral in a particular case typically requires an examination of the subjective intent of the parties. For example, it may be necessary to review the terms of the financing transaction and the financial condition of the borrower and decide whether a reasonable person would extend credit in such a situation without requiring the pledge of stock to be acquired.

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in our interest rate assumptions, and for every one point in growth, you lose $22 billion. And so right now there is about 6 percentage points, about half a percentage point difference there, so that is another $12 billion. You are talking pretty close to about $34 billion in estimates that they are miscalculating right now.

If CBO is accurate, we are going to have to make this gap up sometime in September if we have to go to sequestration. So I happen to believe these economic assumptions are important in terms of how we establish our priorities and the kinds of revenues we are struggling with in the Budget Committee. Whatever the administration assumes, we are going to accept it or we have to make up the $34 billion, and that seems to be the game we have played the last 4 years I have served on the Budget Committee.

Let me ask you this, What should our ultimate deficit reduction target be? Should the goal be to balance the budget, should we run a surplus, and how much should we cut the budget each year in a way that would not trigger recession if we cut too much too soon?

I would like you to comment on the use of the social security trust funds to reduce the budget deficit. Sometime in the future we are going to have to redeem the bonds they are being invested in. Should we have a budget deficit target that includes Social Security, or should we have a budget deficit goal that does not include the Social Security surplus?

Mr. GREENSPAN. Well, first, Congressman, let me say that the speed of adjustment that is embodied in Gramm-Rudman-Hollings is about as good an adjustment process as I can envisage so far as time is concerned. Owing to the shortage of domestic savings, we may very well have to move toward a Federal surplus in order to offset that shortage.

So even though Gramm-Rudman-Hollings moves only to a balanced budget, I think the long-term goal of the Congress should be to create some modest ongoing unified budget surplus rather than just really seek balance per se. We could move faster than Gramm-Rudman-Hollings without disrupting the economy because, as I indicated to the chairman, should there be a credible, rapid decline in the Federal budget, interest rates would fall rather significantly, and the decline in the budget deficit would be offset by increased underlying capital investment as a result of lower interest rates. As a result there would be a balance in the losses to effective demand and in the increases in effective demand.

So I would not be concerned about overdoing the rate of adjustment.

Mr. RUSSO. Mr. Chairman, if I could—I want to get into that response on Social Security. But, as I understand the 1989 budget, and the markets are not stupid, the markets understand the games that are being played in terms of the budget deficit, that if you take the Social Security trust fund off budget and not really count it, in 1989 that generated $41 billion in surplus, while all other trust funds had a $55 billion surplus. So added together, we reduced the budget deficit by about $96 billion down to $151 just by the use of the trust fund surplus, an accounting procedure that didn't really reduce the budget deficit.

So for the financial markets the budget deficit for fiscal 1989 really was $247 billion, and not the $151 billion figure that is reported by counting the trust funds. Is that a good idea, to count the trust funds? Because the Social Security surplus is going to be growing to as much as $200 billion a year. That will reduce the deficit, but is it really reducing the deficit?

Mr. GREENSPAN. Well, let me say, Mr. Russo, that the financial markets are focused almost exclusively on the unified budget deficit, because that is the deficit which has to be financed in the private markets. Remember that Social Security invests in U.S. Treasury securities directly. The result of that is an emphasis on where both the short-term and long-term unified deficit are going. And while markets certainly acknowledged the question you raise, namely the differences between the trust funds and the other parts of the budget, they view the trust funds as financing the rest of the budget, and it is only the net which essentially concerns them with respect to the effects on markets, the effects on the supply and demand for credit.

Mr. RUSSO. But some day we have to redeem those funds, and, as I understand it, we are going to be into the trillions and trillions of dollars in the year 2010 to 2015, and we are going to have to pay for those bonds somewhere down the line on the revenue side of our ledger.

Mr. GREENSPAN. That is certainly the case.

Mr. RUSSO. I am a baby-boomer, and I want it there when I retire, you know. You seem very optimistic about it.

Mr. GREENSPAN. Keep in mind that in the unified budget the interest payments that are made from the Treasury to the Social Security trust fund is washed out. It is an intragovernmental payment.

But if you separate Social Security from the rest of the budget, that payment of interest from the Treasury to the Social Security trust fund, which is, one of the reasons why the Social Security trust fund rises so rapidly is an outlay in the other part of the budget. And so while interest payments to the Social Security trust fund is a major factor helping the fund increase very sharply, separating Social Security will also create an accelerating deficit on the rest of the budget.

So it is going to create some very serious problems for the Budget Committee if one tries to split those apart.

Mr. RUSSO. If you did that, wouldn't you put your budget targets higher? Instead of being zero, you would have to make them higher.

Mr. GREENSPAN. Yes, definitely.

Mr. RUSSO. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Schulze. Mr. Sundquist. Mr. Downey?

Mr. DOWNEY. Mr. Chairman, it is good to see you. Not only do I consider you a fine Chairman of the Federal Reserve, and your testimony is much welcomed today, but a consummate diplomat, and sometimes I have the feeling you are driving around the flame, a moth around a flame afraid to be consumed by a position that may send the markets one way or the other.

But I am going to try to pin you down a little bit, if I can, today because we have to deal with specifics, and while I agree completely with the notion we have to reduce the deficit and do it soon by either spending or tax increases, the realities have been stated to you by Congressmen Russo and Stark and by countless others, that there are priorities out there that will require us to spend money, defense considerations that will not allow us to cut the budget there by much, and domestic priorities that will not allow us the reduction.

So that leaves us with the painful reality of raising revenue, in my view. And I approach this, I suppose, the same way a doctor learns the Hippocratic oath, the first few lines of which are first do no harm, and that is how I view the American economy. If we have to raise revenue to achieve Gramm-Rudman targets this year, can you be somewhat specific in terms of what sort of tax increase you think would do harm, how large an increase would do harm?

And then I am going to ask you about some specific measures in terms of amounts and types of increases that you might elaborate on. First I would like to ask you how big a tax increase if we decide to reach the Gramm-Rudman levels would you be supportive of and do you think would not harm our economy?

Mr. **Greenspan**. Well, first of all, it would be highly desirable to try to resolve the budget deficit problem wholly from the expenditure side. I say that largely because I am fearful that if we try to resolve the long-term deficit problem through taxation we are going to find that it works only in part, perhaps only a small part, because we will eventually find that expenditures creep up and absorb the new revenues.

All taxes do harm. The issue is not finding which of them is harmless—there are none—but finding which do less harm than others. And I have for a number of years, not for revenue purposes, but for economic structure purposes, been strongly supportive of a gasoline tax. And the reason that I have been strongly supportive of it is that it does only a modest amount of harm and promotes conservation.

So that while I wouldn't argue for it as a revenue-raiser, because I strongly believe that we should endeavor to resolve the deficit from the expenditure side, I do think that a gasoline tax makes sense because it would significantly restrain the renewed growth in oil consumption.

Mr. **Downey**. Among evils, would, if I can try and pin you down a bit more, a gasoline tax of 5 cents, let's say, a gallon, increase by 5 cents by over 3 years, what sort of harm do you think that would do to the economy as opposed to, let's say, other excise taxes or possibly eliminating the bubble on the top rate, where we currently, as you know, have a 33-percent rate, at that point is 150, goes back down to 28, as opposed to eliminating that, would a gasoline tax of 5 cents a gallon over 3 or 4 years——

Mr. **Greenspan**. I think that the 1986 Tax Act came out rather well. I would be most reluctant to alter the marginal rate patterns, because I think that considerable good will eventually come from them.

In fact, much good has already come from those changes. I would be most reluctant to see higher rates.

The problem with taxes which embodied themselves in the cost of doing business is that they distort the system. In other words, an oil import fee becomes embodied in the cost of petrochemical feed-stocks and residual fuel and the like, and that will have negative effects. Only in a very small part is that true of a gasoline tax.

I would strongly prefer to stay away from all cost increasing taxes. Increases in either the corporate income tax or the individual income tax would be most unproductive.

Mr. **Downey**. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Vander Jagt?

Mr. **Vander Jagt**. Thank you, Mr. Chairman.

Welcome, Mr. Chairman, back home, where you have been so many times before.

My question arises out of your statement on page 8 that we must recognize that the line between equity and debt has become increasingly fuzzy over recent years. I think the gist of the testimony we have listened to for 3 days is that one of the contributing factors to the stampede to LBO's is how we treat equity and debt in our society and in the Tax Code.

One of the things we have all been fascinated with is "why the sudden surge of LBO's?" One of the answers given by the Secretary of Treasury and others was that it was only recently that Wall Street figured out how to take advantage of this, which would lead me to believe that over the years it has always been difficult to define clearly, for tax purposes anyway, the difference between debt and equity.

Wall Street finally figured out how to push it farther and farther and farther and make more of equity into debt. That is what we have.

My question to you is, as just one small step in addressing this crisis, wouldn't it help to give a more clear definition of debt and equity and maybe define debt as Wall Street used to think it was defined before they went into the junk bonds?

If I could expand on this thought one step further. Maybe one of the ways to get into defining it is to look at a case where junk bonds are returning 17 percent on interest when the prime rate is 10 percent.

Obviously, some of that high interest rate is not just for the use of money; there is an acquisition of an equity there. Is there any way that we can give a more clear definition of the difference between debt and equity?

Mr. **Greenspan**. Congressman, I am afraid you are resurrecting matters that have been discussed in the Internal Revenue Service now for a number of years.

Mr. **Vander Jagt**. Especially between 1969 and 1982?

Mr. **Greenspan**. Yes, indeed.

It is a very difficult problem because of the number of instruments that we have. When you try to put bells and whistles on those instruments, it is very difficult to know just how close you are to debt or equity. It is getting ever-increasingly like a continuum.

That creates a significant definitional problem for the Internal Revenue Service. They have been struggling with that problem, as indeed have the courts.

I naively asked at one point to get a simple definition of what is debt and what is equity. I ended up with a stack like that in which the answer is not yet there.

It may well be that we will have to live with that ambiguity for a while. But there is no question that there are instruments which are debt-like, which have part of their return in an equity form.

In fact, they build them that way. How one struggles to get the appropriate application of principle that you raise and with which I fully agree is going to be extremely difficult.

I am not sure that the Congress can do it.

It probably has to be done by the Internal Revenue Service, which is already required to make this distinction.

Mr. VANDER JAGT. Mr. Chairman, maybe I am as naive as you were when you asked the naive question of a simple definition between debt and equity and got the big stack of papers.

Maybe part of the problem in the struggle of trying to define is that they were dealing with it in too complex a way and didn't recognize that there never is going to be a perfect answer. Perhaps we should start looking in more naive and simple ways. Let me just throw out one suggestion as a groping toward it.

One could argue that all debt is partially a reaching for equity. Even if you just plain borrow money to save a failing company or to keep it alive, you are trying to retain the value of the equity. One of our witnesses yesterday said that if you reduced the deductibility of interest to 86 percent—and maybe that 14 percent would be recognizing some equity even in a debt interest instrument—you could then reduce the deductibility of dividends by 50 percent and it would be revenue neutral. Since there is a gap between how we treat equity and debt, wouldn't that be a constructive step in the right direction, or not?

Mr. GREENSPAN. Well, I am not sure. I don't know that the revenue estimates——

Mr. VANDER JAGT. That was just one witness' testimony. I am not sure either.

Mr. GREENSPAN. The difficulty that you get into when you try to limit interest deductions is that you will cause secondary consequences.

What about banks or finance companies who have huge amounts of interest coming in and huge amounts of interest coming out? Are they included?

Obviously, if you did include them, you would throw them out of business. And if you didn't, what you would find is that nonfinancial corporations would then all proceed to buy financial corporations.

It would cause an extraordinary change in the optimum mix of assets in the economy. I think it would itself create a large wave of new corporate restructuring, which I am not sure would be particularly desirable.

So that before you move in that direction, I think it is very important to go step by step and ask what happens if you do "X" or "Z"?

Mr. VANDER JAGT. Thank you, Mr. Chairman.

It is very helpful.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Guarini.

Mr. GUARINI. Dr. Greenspan, it always is good to see you again. Thank you for your wisdom and your counsel.

We live in a speculator's paradise fueled by mountains of borrowed money, shifting assets, rather than creating wealth, spending time in board rooms and manipulating numbers instead of becoming more productive in the plant. Some people feel, of course, that the greed within our society has gotten to the point that it has actually hurt our productivity.

I am extremely concerned about the level of debt we have. We can get into the philosophy of what is debt, what is equity.

The fact is we have got to recognize that we do have a big Federal budget deficit of $100 billion, assuming we get down to Gramm-Rudman this year. The national debt is $2.7 trillion, which carries a debt service of about $160 billion.

I am concerned about the rising interest rates if a recession hits. Our S&L crisis has a potential cost of $100 billion.

Third World debt in Latin America is $400 billion alone. We keep shifting from equity to debt in our corporate structures with the LBO's. I am wondering whether or not we are not poised for an extremely dangerous position in our economy.

The problem of compounding higher interest rates in a recession can cause a very calamitous effect. I am wondering what your comments are on raising interest rates in a climate like that and whether or not we are overburdened by debt governmental and corporate wise. Every place we turn in our society the same national debate is taking place.

It is always more indebtedness whether we are in the public or the private sector. Can you comment on what happens if we have higher interest rate and what happens if a recession does take place?

Mr. GREENSPAN. First of all, there is no question that the debt burden, however we define it, has been rising and rising very substantially in the private sector. The figure which I find most troublesome is the rise in interest payments for nonfinancial corporations as a percent of a corporate cash-flow before the interest provision. This statistic is up to 35 percent, and a multiple of what it was two or three decades ago.

Obviously, should we run into a recession and corporate cash flow contracts dramatically, excess fixed costs in the system will create very severe problems and would exacerbate the underlying economic structure.

It is precisely because we are concerned with inflationary acceleration, which in turn would lead to very high interest rates and break the back of the economy and lead to the types of difficulties that we are concerned about, that the Federal Reserve throughout 1988 kept ahead of the curve, so to speak, by trying to keep inflationary expectations down. That led, of course, to a moderate rise in interest rates.

But our purpose was to prevent problems from emerging which would have been far more deleterious to the structure and far more of a worry with respect to our debt service problems than any actions that we are taking.

We are very sensitive to the impact of interest rates on the economy, and we hope that our actions will make the interest rate path much lower than it otherwise would be.

Mr. **Guarini**. Should we keep interest rates down by putting a floating cap on the subordinated loans being made which run 18 percent and 20 percent, et cetera, where there is secondary lending taking place at extremely high rates, irresponsible rates sometimes?

Mr. **Greenspan**. I think what we have to distinguish between is the level of risk-free and risky interest rates. By that we usually mean the riskless rates of interest, those substantially involved in U.S. Treasury securities, and the wide variety of other debt instruments that are involved with significant premiums over the riskless rate.

This gets to the question that Mr. Vander Jagt raised, namely, the issue of when do we have debt and when do we have equity?

Many of these extraordinarily high interest, so-called interest paying debt instruments are really partial equity instruments, and it is difficult to make the differentiation.

I would be hesitant to try to arbitrarily cap any of those because what you will succeed in doing is merely eliminating them.

Mr. **Guarini**. How about if you have five points above prime or floating or whatever it is? You have flexibility in there.

Mr. **Greenspan**. You are talking about capping interest rates?

Mr. **Guarini**. Right. We had laws making it illegal beyond a certain rate. I am wondering whether or not these high rates are hurting our economy and making LBO's possible?

Mr. **Greenspan**. I think you will find that if you cap interest rates which are determined in the marketplace, the person who has to pay that interest will not be able to fund in general.

The question you have to ask yourself is that if you cap the rate, what will happen? The answer almost surely is that the lender will disappear and the borrower will not have any source of funds.

Mr. **Guarini**. That might be fine in LBO's.

Thank you, sir.

Mr. **Pease**. I think it is quite understandable, Mr. Chairman, that you did not want to disagree publicly with the Administration on its economic assumptions. You also don't want to shake up the markets by doing so.

I must say I am concerned that your desire not to disagree with the Administration may not well serve this committee or the nation. As an example regarding deficit reduction, you declined to disagree with the administration's economic assumptions for the current budget.

You stated this morning that should the full Reagan budget deficit reduction be adopted, the economic assumptions in the Reagan budget are credible. As Mr. Russo said, the deficit reduction in the Reagan budget, is the result of rosy economic assumptions. Reductions are rather small part of the deficit reduction package.

Are you saying that making the small outlay reduction will lead to the higher growth levels, lower interest rates, and lower inflation predicted by OMB?

Mr. **Greenspan**. Well, remember, Congressman, the budget I have in mind is not only the budget for fiscal year 1990. It is the total budget which implies fairly significant decline in fiscal year 1991 and beyond.

I will state, and I will just repeat because it is actually the case, I am not trying to support the administration. I wouldn't and haven't in the past when I have disagreed.

I am merely saying it is important to understand the implications of that forecast. I am saying and I will repeat, irrespective of how it is done, if the pattern of outlays develops as they propose in fiscal year 1991, 1992, and 1993, and is locked in through authorizations and appropriations, the markets would respond very favorably and interest rates would come down.

I am not saying whether they would come down directly, exactly as I have not looked at their interest forecasts and detail in the context of all this, so I cannot apprise whether the numbers are appropriate. But that interest rates would come down and come down significantly under those conditions, I have, frankly, no doubt.

Mr. Pease. You have no doubt even if in reality we do not meet the Gramm-Rudman targets?

Mr. Greenspan. If the Gramm-Rudman targets are not being met and the markets perceive that they are not being met, interest rates will not come down anywhere near the extent forecast by the administration.

Mr. Pease. Doesn't that suggest that if the Gramm-Rudman targets are being met by the projections of the administration or by the budgets adopted by Congress in a way that involves rosy economic assumptions rather than substantial outlay cuts, that the deficit reductions are nonetheless satisfactory?

Mr. Greenspan. Well, first of all, I was saying that the calendar year 1989 forecasts, which are only in real terms about a half a percent point above where the consensus are well within the range of forecast error.

I would not argue that that is out of line, as I answered earlier to the Chairman. I do find that their longer term forecast to be above what we would consider to be the long-term potential of the economy.

I have discussed that in some detail before the House Banking Committee fairly recently. But I think it is important to remember that any administration has a dilemma in its forecast in that it has to presume that the Congress enacts the budget that it brings forth, and that has certain economic consequences which puts that type of forecast in a different category from most other forecasts, which don't have that restriction on.

Mr. Pease. Mr. Chairman, I appreciate your comments. You spoke before about the corrosive impact of deficits. My question is whether those corrosive impacts are going to be ameliorated if Congress uses the President's economic assumptions and adopts a budget where we meet the Gramm-Rudman targets, but does so in a sham manner so that any knowledgeable economist knows when we pass it—and we know—that it is at least $20 billion off.

Won't the real deficit be $20 billion higher than we stated when we allegedly met the Gramm-Rudman targets?

Mr. Greenspan. I think the markets obviously are aware that there is a difference between the Gramm-Rudman targets and what actually occurs after the fact.

At an earlier testimony, I think it was Tuesday, at the Joint Economic Committee, I said that if the budget deficits were actually brought down in fiscal year 1990 to $110 or $120 billion—I mean actually after the fact—that would be perceived by the markets very favorably.

But I do think that markets look at the Gramm-Rudman process as being useful and as a mechanism which helps to bring the deficits down. I don't think they are being unrealistic about that.

Mr. PEASE. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Matsui.

Mr. MATSUI. I also would like to thank you, Mr. Greenspan for your testimony.

When we started this process, most of us were suggesting that perhaps there could be some revenue gain by solving problems in the area of leverage buyouts. I am finding that is wishful thinking.

In fact, the solution we want to develop would probably create a revenue loss because the action should be to limit the double taxation of dividends rather than to limit interest deductions. Limiting deductibility of interest would make it easier for foreigners to purchase companies and increase the cost of capital.

You have pretty much ruled out disallowing some of the interest deduction as a way to pay for the deductibility of dividends.

Yesterday Mr. Rohatyn testified before our committee. He suggested, as an alternative to find revenues, that we should perhaps look at taxing short-term capital gains. Is that something you would consider if we want to level the playing field?

Mr. GREENSPAN. When the 1986 Tax Reform Act was passed, the one aspect I felt uncomfortable with was the increase in the capital gains tax rate. I would very much not like to see it raised.

In fact, it would be preferable not to unwind the 1986 act by lowering the capital gains tax. So that I would not agree with Mr. Rohatyn on that issue, although I must say on a number of issues I find his views quite useful.

Mr. MATSUI. Would the increase in the capital gains tax for short-term transactions be warranted to deal with the leverage buyouts problem?

In comparison, what would be less harmful?

Mr. GREENSPAN. I am sure it would make a number of elements involved in leverage buyouts less profitable. But I would be concerned that while that might take some of the froth off the LBO boom, and I don't consider that bad, it would also create a lot of problems which may outweigh the advantages.

Mr. MATSUI. Assuming we want to level the playing field by allowing some deductibility of dividends, what would you suggest as the source of revenues that would do the least harm to the economy.

I realize it is a very broad question, but I think we may face that issue if we begin to mark up legislation.

Mr. GREENSPAN. Having looked at the LBO, and more generally the restructuring phenomenon, I concluded the major cause, not the sole cause, but the major cause has been the extraordinarily volatility of the American economy in the 1980's, which threw a number of corporate structures off kilter and created opportunities to make profits by putting them back together again in a more optimum fashion.

I suspect that we have already gone through a goodly part of the American economic structure that is susceptible to leveraged buyouts, and that we are probably not far from peaking in that process. So I am not strongly supportive of major actions taken for the sole purpose of undercutting that particular process.

Nonetheless, there is a major question with respect to the taxation of capital income which the LBO process has surfaced. It really has emphasized problems which occur as a consequence of double taxation of dividends.

That is something which I believe should be on this committee's agenda for the longer term, not necessarily a short-term fix, so to speak. Should the budget deficit problem be substantially resolved, I would bring that up on the agenda, but I would not put it ahead of solving the budget deficit.

To the extent it worsens the deficit, I would think it better to live for a while with the double taxation of dividends than try to resolve that at this stage. In any event, I don't think it is crucial to get to the LBO problem in the short term.

Mr. MATSUI. Are you saying there probably will not be many more LBO's, such as KKR of Nabisco?

Mr. GREENSPAN. I think there will be a considerable amount.

I just think that the whole thing has probably peaked. There is still a lot of it out there.

Mr. MATSUI. Is the reason we have not seen a lot of activity in the financial markets because we are holding these hearings? We began to discuss this matter in earnest around last September.

Are many of those involved in LBO's saying: let's sit back and wait while Congress gets over their frenzy?

Mr. GREENSPAN. I am sure that is the case. I am not looking at the period of the last 2 months and saying it slowed down, therefore, it must be over.

I was looking at more the underlying economic incentives to do it which I believe to be cresting.

Mr. RANGEL. The Chair recognizes Mr. Levin.

Mr. SANDER M. LEVIN. Thank you, Mr. Chairman.

Mr. Chairman, your nuances are so important that you state degrees very carefully.

Let me, if I might, ask you some bottom line, or discuss with you some bottom line questions.

I think Mr. Matsui's questions have kind of fleshed out your feeling about action by this committee on LBO's. You say on page 9, "All that doesn't mean that we should do nothing."

Then you immediately go on to say that, "One option that you might find attractive would cost a lot, and we don't have the money now."

So I think really what you are saying is all that doesn't mean that we should do nothing now. But I don't know that you are suggesting we do anything now.

Mr. GREENSPAN. It depends on whether you are looking at it from the point of view of the Ways and Means Committee or from the viewpoint of total government.

I do think that legislative initiatives at this are not terribly useful, at this stage because we don't have the money to correct the double taxation of dividends.

However, I do believe the supervisory authorities such as the Federal Reserve, have to look at LBO lending by the banks and that we have to review our processes of examination to make certain that we do not upend our banking system.

So I do believe that we, the Comptroller of Currency and the FDIC, have important responsibilities in the area of supervision.

Mr. SANDER M. LEVIN. Your bottom line response is that Congress should do nothing now, perhaps, later, if there is any action that should be done on the regulatory side? That seems a fair summary?

Mr. GREENSPAN. Yes, I would agree with that.

Mr. SANDER M. LEVIN. Because we need to in the end get advice where the nuances are clear. I respect that you tend to always speak in nuances.

Because every mole hill is a mountain in a sense when you speak; at least it could be.

Let me now turn to the other area we discussed. I thought Mr. Pease's questions and Mr. Russo's tended to flesh out where you were coming from.

It is my own view that when you minimize the differences on economic assumptions, that you very much diminish the chances for strong action here. So much of the argument relates to economic assumptions.

The history is that the administration and Congress have used economic assumptions which turned out to be false and which we knew going in were not likely to be true. We have used them not as an excuse for inaction, because we have done some things here, but clearly not enough.

I know that you need to be very cautious when you, for instance, criticize the longer term assumptions of the administration. You say you have your differences.

But when you diminish the significance of those differences, you really tend to move us toward less action. In a word, when you hedge, we tend to hold off. I think you know that.

The predictions are that we will be $10 billion off at least in terms of the present fiscal year. In terms of the longer range, the differences really aren't insignificant, are they?

Mr. GREENSPAN. We are dealing with an order of magnitude of a half a percent in real growth over the longer term, maybe slightly more, which is not a small number over the longer term.

Mr. Levin, I have been in the economic forecasting business for decades. When I was a private citizen that was my occupation. I am sufficiently aware of where the errors can emerge to know that.

For me to make a major difference in the short run of several tenths of a percentage point in real growth far exceeds my or anybody else's forecasting capability.

While I don't disagree that our hedging has the effect that you are suggesting, I cannot in all honesty argue strenuously that one forecast is right and one forecast is wrong when all of my history tells me that that is an exaggeration.

Mr. SANDER M. LEVIN. How about longer term? Do you feel the same about their longer terms?

Mr. GREENSPAN. As I said before, I think that the longer term forecast presupposes an increase in productivity which I find improbable.

Mr. SANDER M. LEVIN. Your advice to us is to discount, if not disregard—I will use a more cautious word—discount the economic assumptions of the administration long term?

Mr. GREENSPAN. I am not saying they are outside the realm of credibility. They are in that range.

I just personally find their assumption of close to 2-percent annual productivity growth a less than 50/50 probability. I feel much more comfortable in projecting a lower number, which we have.

When I mentioned before the House Banking Committee that we believe the potential of the economy is in the longrun between 2½ and 3 percent, we have a number in there roughly a half a percentage point lower on long-term productivity than that in the Counsel of Economic Advisers report. Can they be right and we wrong?

The answer is, "Certainly". Do I think that is going to happen? No, no. If I did, I would change.

Mr. SANDER M. LEVIN. Thank you.

Mr. RANGEL. The Chair recognizes Mr. Moody.

Mr. MOODY. Thank you.

I certainly want to join my colleagues in commending you on the job and the leadership you have been showing.

On the question of assumptions, clearly the administration and the CBO both can be said to have an ax to grind on these matters of forward projections.

The blue chip forecast is probably one which has no specific ax to grind. What strikes me is the enormous difference between the blue chip forecast and the administration forecast.

Here we are not talking about small one-half of a percentage point difference. For 1989 the administration is projecting 3.5-percent growth rate.

The blue chips are projecting 2.3 percent in real terms. That is an enormous difference for 1989.

For 1990, where, of course, information is tougher to forecast and less reliable, the differences are more dramatic—3.4 percent by the administration versus 1.9 percent by the blue chip.

We are not talking about small estimations of forecasting errors here. We are talking about enormous magnitudes of difference; 3.4 versus 1.9 is well beyond the kind of distinctions you are presenting to my colleague.

Let me move on and ask you to comment. The comparison, I think, is striking.

The CBO and the administration is 3.5 versus 2.9 for 1989. It is 3.4 for the administration versus 2.2 for the CBO. Those are bigger than the amounts you have been describing.

If I told you that a great nation was going to rapidly increase its growth rate from currently 2.6 to 3.5, and I told you at the same time that interest rates are going to sharply drop from their current level for 30-day rates down to 6.3, what would your reaction be to the internal consistency of that movement?

On the one hand we have a rapidly increasing rate of growth and on the other we have a sharp drop in the rate of interest.

Mr. **Greenspan**. Well, remember, Mr. Moody, that the Reagan forecast, as I indicated earlier, presupposes a very dramatic improvement in the Federal budget. In effect, it presupposes that the Congress will pass all of its budgetary requests in full.

As I have indicated here and I have indicated many times in the past, it is my expectation that should, in fact, the deficit be brought down dramatically and credibly, that interest rates will fall and fall quite appreciably.

Real interest rates currently are still well above what they were during most of the post World War II period. They would fall a good deal if economic conditions very significantly improve.

I don't find that the internal logic of their position as being erroneous. I might also add that while I feel uncomfortable with their 2 percent, near 2 percent increase in productivity over the long run, there is a certain validity in arguing that with a decline of the type that they are projecting or requesting, in the Federal budget, that it is possible that there would be a significant capital goods boom which could both add to the capacity and improve productivity. So it is not an internally inconsistent forecast.

It is based upon a projection of actions relative to the budget which I suspect in a whole set of private forecasters, the blue chip group, would not consider credible.

Mr. **Moody**. Don't you think the private forecasters of blue chips assume somehow willy-nilly we were going to get down to the Gramm-Rudman level?

Mr. **Greenspan**. Not necessarily.

Mr. **Moody**. The private sector must have assumed Gramm-Rudman would be met. That is what is so striking, the difference of private forecast of interest rates and the Reagan administration forecasts, although both must assume necessarily we met our Gramm-Rudman targets.

I don't know how you could possibly believe interest rates would fall to those levels—5.5 in 1990.

Mr. **Greenspan**. Well, I think that there are some who are concerned that the Congress will alter Gramm-Rudman-Hollings, alter the structure of the legislation and the goals if it gets too tough.

There is still a large degree of cynicism out there in the private sector. Although I must say it is somewhat diminished from what it was.

But I would argue that the range in the various different forecasts are still within what has historically occurred over a period of time. We look at forecasting accuracies, private economists, government, CEA, even the Federal research, the range of errors are somewhat disturbing to those of us who are in the forecasting profession.

Mr. **Moody**. Thank you.

My time has expired.

Chairman **Rostenkowski**. Mr. Coyne.

Mr. **Coyne**. I have no questions.

Chairman **Rostenkowski**. Mr. Dorgan.

Mr. **Dorgan**. Thank you, Mr. Chairman.

Mr. Chairman, I would be remiss if I didn't just provide you with a perspective on the gas tax. I did intend to do that.

I want to remind you, coming from a Western State, that the imposition of an additional gas tax poses unfair burdens. A person who works with me comes from Brooklyn. She tells me when her family would go to visit relatives in Bayonne, it was a major trip. They would pack sandwiches, plan it for weeks, and finally visit Bayonne.

In North Dakota, after supper, people would travel 100 miles for a tractor part. We drive a lot more in North Dakota than citizens in New York.

If one suggests raising the gasoline tax as a way to reduce the deficit, one is really saying to those of us in the West, you should pay twice as much to reduce the deficit as those in the East.

I am sure you are aware of this discrimination and you understand the passion with which many of us raise these points in the context of deficit reduction.

Having listened to Secretary Brady and many other distinguished witnesses, including yourself, it is surprising to see the startling difference with which we view things.

Some of us believe that the mergers and LBO activity is an economic demolition derby. Others watch exactly the same thing and see it as a Sunday drive, and suggest there is not very much wrong.

My notion is that the economy is involved in wild speculation that is not good for this country's economy. Some of the testimony in the recent days has suggested that much of this wild speculation and increase in debt and hostile takeovers and so on, could not have occurred without the financial institutions participating in that type of leveraging.

Mr. Rohatyn, among others, has testified there has been a massive failure by regulatory agencies. You are undoubtedly familiar with terms such as junk bonds.

All of those are used by securities firms and investment houses. In the 1987 crash, Mr. Rohatyn testified yesterday that the Fed advised the banks to provide whatever liquidity was necessary to secure these houses during that crisis period.

His point was, therefore, the Fed has an interest in not only making sure there is an adequacy of capital for banks, but also security houses, based on what the Fed did in the 1987 crash.

If that is the case, one wonders if the Fed ought not be more mindful and concerned about what some of the security houses and investment bankers are doing in the area of debt. I would like you to comment on that perspective.

Mr. GREENSPAN. Without confirming or denying what it is we did or did not do in 1987 during the crash, obviously, we are most concerned about the total financial structure and its elements and the various difficulties that could or could not emerge.

The whole interest of the Federal Reserve is to see that financial system is sound and there is safe and sound banking, particularly. We, obviously, have been sensitive to the LBO problem for quite a while.

We have a whole series of examination guidelines from 1984. We have been looking at the process continuously since. The FDIC and the Office of Comptroller of the Currency have been looking very closely.

We are acutely aware of this process and what the dangers could be. I don't want to say to you that we don't care or that, in fact, there has been a supervisory glitch here because I don't think there has been.

I think that we have been sensitive to this issue and have been fairly close to it for a number of years.

Mr. DORGAN. I appreciate that answer.

Mr. Rohatyn testified—and my recollection was that the Fed was doing what was necessary to suggest that banks provide the liquidity necessary to overcome this crisis, the liquidity necessary——

Mr. GREENSPAN. I think that is not exactly the way I would put it nor exactly the way it was.

Mr. DORGAN. Could you tell us exactly the way it was?

Mr. GREENSPAN. What we did was stand ready to supply liquidity, but we are acutely aware of the fact that there are issues of safety and soundness in the banking system even during the period such as the immediate post crash period, and we clearly would not say to banks open up your window and let the cash flow out because that is not the way the system works, nor should it.

Mr. DORGAN. In that crisis you stood by to provide the liquidity. Investment banking houses are providing bridge loans which some testify are in excess of the capital structure of the investment houses themselves. Doesn't this cause you concern?

Mr. GREENSPAN. The liquidity that is involved here is supplying reserves for the banking system. That does not mean we stand ready to give loans to finance bridge loans of investment banking houses. That is not what we were preparing to do.

Our main concern during that period was the commercial banking system and the financial structure. It was not basically to open up the wallet of the Federal Reserve, so to speak, and finance everybody's loans, which we cannot, should not, and will not do.

Our major concern is the stability of the system, and we have a fairly systematic, calibrated means to achieve that. Hopefully, we do it in a manner as we did then, without in the process creating secondary consequences which we would have to live with.

Mr. DORGAN. Mr. Greenspan, I have studied and taught economics. One of the rudimentary lessons is the business cycle has both ups and downs and no one has been able to invent a substitute.

We have been in the throes of a business cycle which has been moving up for some time. I know you understand we will have an economic downturn. The question is when?

I wonder if all of what is going on today causes concern as to when that downturn occurs and its ramifications for the banking and securities industries?

Mr. GREENSPAN. We are aware of what would happen to this economy the next time it turns down. I don't believe the business cycle has been repealed.

We are going to have recessions in the future. As I said to the Joint Economic Committee, on Tuesday, at the moment the economy looks fairly stable. We cannot say at the moment that we see significant imbalances or that we are on the edge of a recession.

At some point something will go wrong. Either we will get speculative flurries of inventory investment or we will get different types of imbalances which will have to be corrected, and we will have a recession. I don't know when that will be.

Chairman ROSTENKOWSKI. Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman.

Mr. Chairman, thank you for being so patient.

Your observations this morning have been very useful.

I would like to talk about the gasoline sales tax. Those of us from Western States—I am from Houston—are concerned about the disproportionate burden placed on Sunbelt States by that kind of tax. My good friend from New York, Tom Downey, I think brought it up today.

Since you didn't have an opportunity to respond to Mr. Dorgan's comment on the disproportionate leveling of that kind of tax, I wonder if you would do so now?

Mr. GREENSPAN. There is no question that the incidence of that tax does vary significantly with geography. As I said there is no such thing as a tax which is not harmful. You are indicating some of the harm that exists.

The crucial issue that I was raising is the difference between a tax or a fee, such as an import fee, which builds into the business cost structure of the economy, and a tax which does not. I would say that cost-raising taxes are the most deleterious form of taxation.

I fully sympathize with your concerns, which help explain why the gasoline tax in this country is so much lower than in other countries.

Nonetheless, the gasoline tax primarily affects final demand or final sales or consumption.

In other words, it is the tail end of the business process and does not get passed on into another layer or cost to the business sector. It is only in that sense that I am referring to it as a lesser evil.

Mr. ANDREWS. What would your thoughts be about other excise taxes, tobacco, beer, wine?

Mr. GREENSPAN. Remember——

Mr. ANDREWS. Similar view?

Mr. GREENSPAN. I myself am not advocating this because I think we would be far better off to do budget restriction from the expenditure side.

But, clearly, taxes differ. Clearly, an excise tax on something used in business will work its way through.

But a tax on tobacco clearly will not. That is a final consumption tax not dissimilar to the gasoline tax.

Mr. ANDREWS. Let me ask you to go back to your testimony. You made a comment that gave me pause. You suggested that if we dealt on the interest deduction side in trying to curtail LBO's, we may give an edge to foreign investors.

What are your thoughts about taking that kind of action as was suggested in the questions and answers the day before yesterday with the Secretary? What are your thoughts about our international trading partners, specifically those trading partners along the Pacific Rim? Would we not put ourselves at a disadvantage if we capped in some way interest deductions?

Mr. GREENSPAN. We are at a disadvantage now. The Japanese and others already have a lower cost of capital than ours. Were we to cap interest deductibility, I think we would widen the gap to our disadvantage.

Mr. ANDREWS. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Ford.

Mr. FORD. Thank you, Mr. Chairman.

Mr. Greenspan, to pick up where my colleague just left off, he talked about the enormous interest rates on the deductions of the claims for most LBO's.

In addition, the accompanying bank debt increases, the money supply as commercial banks present those notes to the Federal Reserve for rediscounting. My question is, Which of these do you consider the most desirable results, for those deductions to operate to enrich a few managers and takeover special interests or to also finance a capital estate for employees of a company who must work to generate the revenue to repay that debt, or does it matter?

I guess I am referring to employees stock ownership. I have heard a lot of talk about the acquisition and leverage buyouts, but little talk about the employees stock ownership when we talk about these LBO's.

Mr. GREENSPAN. I am sorry. I am not quite sure I understand your question, Mr. Ford.

Mr. FORD. Basically, we are talking about these LBO's in a sense that employee stock ownership or employees have not participated in at all.

When we look, and think in terms of these enormous interest deductions that are being taken by the LBO's, what is your position as it relates to employees stock ownership being a part of the LBO's?

Mr. GREENSPAN. Well, I support the broadest corporate ownership that we can get.

To the extent that employees have a significant stake in the companies for whom they work, that is all to the good. I think that anything that can be done to enhance that is desirable.

LBO's and the very large fees which you noted, are a consequence of a highly unstable economic environment that occurred in the early part of the 1980's. That environment made a number of previously optimally structured companies less desirable.

Throwing these companies off kilter created a very significant amount of potential profitability from restructuring. The result of that is very large fees. Very large amounts of money are involved and fees are correspondingly large. But fees are only a sympton of a more deep-seated problem, caused by the instability of the system.

The best way to handle that without creating secondary consequences is to try to get back to a more stable, more sensible, economic environment in which we do not get the high degree of instability and the required restructures involved with it.

So rather than look at the symptoms of the problem, and these are symptoms, I would frankly tend to look at the more deep-seated causes and recognize that if we try to solve the symptoms we are going to miss the deep-seated causes. So I would say that at the moment, it is probably not sensible to engage in a major legislative agenda to resolve this question, especially since I suspect LBO's may already have peaked.

Mr. FORD. But currently the specialists and managers are those who rake in the profits. Under the employee stock ownership it is broadening that field of employees who will have to work hard to repay down this huge debt that has been built up.

Mr. GREENSPAN. Let me amend my earlier remarks. In innumerable cases employee-owned stock has gone up very appreciably in these buyouts, and employees have considerably benefited. More generally, to the extent that these stocks are held in pension funds employees have benefited indirectly.

So it is not as though one small group has benefited at the expense of everybody else. On the contrary, there have been, as I said in my remarks, up to half a trillion dollars in profits as a consequence of the restructuring since 1982. And pension funds have benefited very appreciably from that, as have ESOP's, although I certainly grant you it looks as though benefits are unequally shared.

Mr. FORD. Do you think it is healthy for the economy with so few people sharing in these LBO's?

Mr. GREENSPAN. I don't think it is healthy for an economy to be heavily distorted by high real interest rates, by very highly unstable inflationary pressures. I think the restructurings that have occurred, and specifically the leveraged buyout part of the restructuring, is a response to that significant distortion. I don't deny that in the process of trying to put the thing back right, one sees inequities occurring, and I probably would agree with you in part, and I would have my own concerns about what inequities I see.

But I think those are the symptoms of the more deep-seated problem, and I would not be inclined to try to solve them directly but would rather address the underlying problems that cause the restructurings themselves.

Mr. FORD. Thank you very much.

Chairman ROSTENKOWSKI. I believe that we have exhausted the questions, Mr. Chairman. Thank you very much for joining us. You have been a tremendous help. I want you to know how much we on the committee appreciate the fact that you participated in this discussion. We look forward to having many more meetings with you, Mr. Chairman. Thank you.

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I look forward to my next invitation.

[The following questions from Congressman Coyne, and responses, were subsequently received:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

March 3, 1989

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for your letter of February 21 enclosing written questions in connection with the hearing held on February 2 on Tax Policy Aspects of Mergers and Acquisitions. I am pleased to enclose my responses to the questions for inclusion in the record of the hearing.

I hope this information is useful. Please let me know if I can be of further assistance.

Sincerely,

Alan Greenspan

Enclosures

Chairman Greenspan subsequently submitted the following in response to written questions from Congressman Coyne in connection with the hearing held on February 2, 1989:

Question 1: Your testimony says that the Fed has "cautioned banks...that they should make certain that they examine the prospects for LBO loans under a range of economic and financial circumstances." Under what circumstances would the Fed exercise its regulatory authority beyond issuing cautions?

Answer: Federal Reserve examiners review the internal policies, systems and controls, as well as the asset quality, of state member banks and bank holding companies engaged in LBOs and other highly leveraged financings (HLFs). A copy of the Federal Reserve's recently revised examination guidelines is attached.

In general, the Federal Reserve expects organizations engaged in these activities to have internal policies, systems, and controls that are adequate in light of the potential risks associated with HLFs. Prudent policies and procedures would normally include reasonable "in-house" exposure limits; credit review and approval procedures that take account of the potential effects of a change in the general level of economic activity, the borrower's financial performance, or interest rates, on the borrower's cash flow and collateral values; effective internal tracking and reporting systems for senior management and the directors; and procedures for ensuring that all related fees are properly recognized.

In addition to evaluating a lender's internal policies and systems, examiners are also instructed to evaluate the quality of the institution's loan portfolio, including the status and condition of its HLF exposures. Loans that involve excessive risks, or loans where repayment is based upon inadequate cash flow or the speculative sale of assets, would be criticized by examiners. Moreover, excessive concentrations of loans to particular industrial sectors, or undue concentrations that would be adversely affected by common economic developments, would also be brought to the attention of management.

Banking organizations are expected to address and correct significant deficiencies in any of these areas. The banking agencies have an array of supervisory tools to deal with these matters ranging from meetings with management and directors to formal administrative enforcement actions, including the issuance of cease and desist orders. Organizations whose loans are considered to entail higher than normal risks would be expected to establish adequate loan loss reserves and strengthen their internal credit review and approval procedures. In addition, such organizations would be required to develop and implement plans to increase their capital positions to levels that are considered adequate in light of the overall quality of their loan portfolios.

Question 2: According to the New York Times, you said that the Fed's analysis of the LBO situation "would lend [you] to do very little with respect to legislation but a lot with respect to supervision, especially in the banking area." What can Congress do to insure that the appropriate amount of supervision is taking place?

Answer: The response to question 1 and the attached HLF examination guidelines set forth some of the steps the Federal Reserve has taken to strengthen supervision regarding LBOs and HLFs. Obviously Congress, too, plays an extremely important role in assuring an adequate level of supervision and regulation of our nation's financial institutions, particularly in the conduct of its legislative and oversight functions and by encouraging and supporting initiatives of the banking agencies to strengthen, where necessary, the basic supervisory framework. In the past, Congress has supported supervisory efforts to require banking organizations to strengthen their capital positions in order to enhance the soundness of individual institutions and promote the stability of the banking system. Through its oversight activities and hearings on important issues, such as LBOs, the Congress has also helped to focus attention on developments that could have significant implications for the condition of our financial system. Such activities, as well as efforts to ensure that the banking agencies have adequate resources to address important supervisory issues, are essential to maintaining an effective supervisory framework.

Congress also will play an important role in reviewing and approving the President's plan for the reform and recovery of the thrift industry. In addition to effectively addressing the serious problems in the thrift industry, the proposed legislation will also help to strengthen depository institutions more generally and enhance the supervisory agencies' regulatory and enforcement authority. Moreover, we continue to believe that the Congress should act to broaden the securities powers of banking organizations by repealing the Glass-Steagall Act's separation of investment and commercial banking within the context of the strengthened prudential framework and "firewalls" long advocated by the Federal Reserve Board. This will enhance banks' competitive positions, result in important benefits to users of bank services, and, at the same time, insulate the bank and the Federal safety net from any additional risks involved.

Question 3: Over the past six months, it has been reported that the Federal Reserve Board believes the nation is currently at the non-accelerating inflation rate of unemployment and that we're close to the maximum level of production with respect to capital. It is expected that you will tighten up the money supply to slow down the growth rate. This should have the effect of increasing the interest rate. As you know, a number of LBOs are financed with short-term loans with interest rates that can be renegotiated. When the Fed makes its decision on monetary policy, will you take into consideration the impact of higher interest rates on corporate debt?

Answer: The Federal Reserve recognized that some business firms that have been involved in LBOs, mergers, or other restructurings, as well as some other borrowers, may well experience financial stress owing to the interaction of relatively high debt ratios with rising short-term interest rates, should such an increase occur. The Federal Reserve is concerned about the implications of such stress for the overall health of the economy and financial markets, and takes account of such developments in formulating monetary policy. That policy, however, must be keyed to our broad economic goals of sustainable economic growth and reasonable price stability, rather than to the needs of particular borrowing sectors. By pursuing policies designed to foster reasonable price stability, the Federal Reserve is putting into place conditions that should encourage lower interest rates, a more stable financial system, and sustainable economic growth over the long run. Lower interest rates would also be promoted by a fiscal policy designed to reduce the federal budget deficit and thereby increase national saving.

Question 4: We've been told by the Congressional Budget Office that a one percentage-point increase in the interest rate will increase service on the national debt by $10 billion. Can you estimate for us what impact a one percentage-point increase in the prime rate would have on corporate debt service?

Answer: There is no precise, all purpose answer that can be given to your question. Clearly, a higher prime rate does tend to raise corporate debt service, but the amount will depend on innumerable factors. Corporations finance themselves through many different channels, including many fixed-rate vehicles. Over any time span the response of debt service costs to a change in rates will depend on the full structure of debt obligations and how that may change in reaction to rate movements. (It should be noted that many firms also hold sizeable amounts of financial assets, which implies another effect of changing interest rates on corporate cash flow.) Lacking the detailed information on private debt that we have for Treasury debt, we really can't make the same sort of estimate for corporations, even on a "static" basis, that we can for the government. Moreover, to get at the vulnerability of firms to rising debt costs, as your other questions suggest, one would want to focus on the issue at a disaggregated level.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

February 16, 1989

TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: **Highly Leveraged Financings**

Highly leveraged financings (HLFs), including leveraged buyouts, have become an increasingly important and prevalent technique for financing acquisitions and for other purposes. Participation of banking organizations in such activities is not considered inappropriate so long as it is conducted in a sound and prudent manner. However, the involvement of banking organizations, including commercial banks and their holding company affiliates, in highly leveraged financing arrangements may have significant implications for the quality of their asset portfolios and their overall levels of risk exposure.

HLFs involve many of the same characteristics and risks that have traditionally been evaluated by supervisors during on-site examinations. These relate to the borrower's income, cash flow, and general ability to pay interest and principal on outstanding debt, economic conditions and trends, the individual borrower's future prospects, the quality and continuity of the borrower's management, and the borrower's ability to realize value through the sale or liquidation of assets. What usually distinguishes HLFs from typical bank loans is the level of debt the borrower assumes in relation to standard measures of financial capacity or ability to repay. Clearly, a high level of debt in relation to net worth or total assets can place heavy demands on a borrower's cash flow and reduce the borrower's ability to absorb the effects of unanticipated financial shocks or economic adversity.

Banking organizations participate in HLFs at a number of levels. First, banks, together with other institutional lenders, may provide senior secured financing that typically represents the largest portion of an HLF. In addition, banks, bank holding companies and/or their nonbank subsidiaries may take equity positions or extend credit on a subordinated basis (mezzanine financing). Bridge loans represent one type of subordinated financing that is generally unsecured and depends on the successful marketing of longer term securities or the sale of assets for repayment. Finally, bank holding companies may invest in LBO funds that are managed by investment banking companies or other third parties.

To the extent that high leverage increases the vulnerability of borrowers to adverse market and financial developments, HLFs have the potential to raise the level of risk in bank loan portfolios. For these reasons, the Federal Reserve has actively urged bank management to exercise caution and apply especially rigorous lending and investing standards in participating in LBOs and other highly leveraged transactions.

In general, banking organizations involved in HLFs are expected to i) evaluate the adequacy and stability of the borrower's current and prospective cash flow under varying economic scenarios, including the possibility of an economic decline; ii) set reasonable "in-house" limits on a consolidated holding company basis regarding exposure to individual borrowers, total exposure to all HLF borrowers, and industry concentrations resulting from HLFs; iii) establish credit analysis, approval and review procedures that take account of the high levels of debt involved in these transactions; iv) maintain internal systems, controls and reporting procedures that track the performance and condition of individual exposures, monitor the organization's compliance with internal procedures and limits, and keep senior management and the directors adequately informed on a timely basis of the organization's involvement in HLFs; v) establish pricing policies and practices that take account in a prudent manner of the tradeoff between risk and return; and vi) avoid compromising sound banking practices in an effort to broaden market share or realize substantial fees.

Banking organizations should establish appropriate policies, procedures and controls before becoming involved in HLFs. In addition, significant policies and procedures, including internal lending limits and credit review and approval procedures, should be approved and reviewed periodically by the organization's board of directors.

Bank holding company HLF exposures should be monitored on a consolidated basis and should take account of loans and holdings of debt and equity securities issued in connection with HLFs, as well as any ordinary business loans to the same obligor. In addition, each holding company subsidiary participating in a HLF should establish reasonable exposure limits and appropriate credit review and approval procedures that call for an independent appraisal of the loan or investment. In particular, banks making loans to borrowers whose obligations are being underwritten by securities affiliates have an obligation to make a complete and "arms-length" assessment of the credit risks in accordance with the provisions spelled out in the Board's Section 20 orders.

Banking organizations purchasing participations in HLFs originated by other firms have the responsibility to make their own thorough and independent evaluation of the transaction and the risks involved before advancing any funds. Once the participation is purchased, such organizations should carefully monitor the borrower's performance throughout the life of the loan. All institutions engaged in highly leveraged financing transactions must assure that related fees and commissions are accounted for in accordance with generally accepted accounting principles. Finally, banking institutions engaged in these transactions should maintain loan loss reserves and capital positions that are fully adequate, given the nature and composition of their HLF portfolios, as well as their exposures to any other borrowers with significant leverage.

In view of the recent increase in the volume and size of LBOs and other restructuring transactions, HLFs continue to warrant the close attention of bank and holding company managers and directors. Such transactions should also continue to be carefully reviewed during on-site examinations and inspections. This is particularly important since the performance of these loans generally has not yet been tested in a period of economic decline. Any significant portfolio risks need to be identified and brought to the attention of senior management and the directors. In addition, any weaknesses in lending and underwriting standards or practices, or deficiencies in internal review, approval and control mechanisms, need to be addressed.

In the course of on-site examinations of banks and bank holding companies, examiners should review the organization's overall involvement in HLFs, as well as the individual loans and other forms of exposure associated with these transactions. The attachment to this letter sets forth general examination guidelines intended to underscore and supplement existing loan review procedures. Significant deficiencies or risks regarding a banking organization's HLFs should be discussed on page one of the examination report and brought to the attention of the board of directors.

The general criteria for identifying HLFs for examination purposes are set forth in the attached examination guidelines. In brief, HLFs are defined as exposures that meet two conditions. First, the exposures comprise loans and other claims assumed in connection with corporate restructurings, such as leveraged buyouts and similar transactions and corporate acquisitions or mergers funded with borrowed money. The definition also includes significant stock buybacks and cash dividends funded with debt. Second, HLFs are deemed to involve loans and other exposures to borrowers whose total debt-to-total assets ratios exceed 75 percent. In addition to this general leverage criterion, examiners may also consider the norms and standards for leverage in particular industries, as well as the cash flow-to-debt service coverage in individual transactions in determining what constitutes an HLF.

It is important to stress that these criteria are general guidelines. They are not meant to imply criticism of any particular transaction, nor to suggest what is deemed to be an appropriate degree of leverage in any particular industry.

Rather, the guidelines represent an additional tool to assist examiners in identifying in the first instance exposures that may warrant closer scrutiny. Any criticisms of specific transactions should be based upon an in-depth evaluation of all of the factors affecting the quality of the exposure, including the adequacy of the borrower's earnings, cash flow and collateral, as well as the quality of the borrower's financial, managerial and operating performance.

The attached guidelines, which supersede the Federal Reserve's SR letter on leveraged buyouts dated June 7, 1984, may be revised or refined in the future in light of changing conditions or practices within the banking industry.

William Taylor
Staff Director

Attachment

Attachment

EXAMINATION GUIDELINES REGARDING HIGHLY LEVERAGED FINANCING TRANSACTIONS

General comments regarding the definition of HLFs

- Examiners should review an organization's internal definition of HLFs to determine whether it reflects the risk factors associated with these transactions.

- For purposes of assessing an organization's HLF activities in examination and inspection reports, HLFs are defined as exposures that meet both of the following two conditions: First, credit is extended in connection with an acquisition by, or a restructuring of, the organization. Typically, such credits are extended to enable the employees, management, directors, or outside investors, acting individually or jointly, to gain effective control of an organization through the purchase of stock and/or acquisition of assets. Thus, the definition includes leveraged buyouts and similar transactions, as well as corporate mergers and acquisitions funded by debt. Significant company buybacks of stock and large cash dividends financed through borrowings may also be included. Second, the extension of credit results in "high leverage" or is made to an already highly leveraged organization. As a general guideline, high leverage is defined for this purpose as a total debt-to-total assets ratio exceeding 75 percent. In addition to this leverage benchmark, examiners may also take account of the norms and standards for leverage in a particular industry as well as the cash flow-to-debt service coverage for a particular transaction in determining what constitutes an HLF.

- Total exposure to individual HLF borrowers includes all loans, extensions of credit, and debt and equity securities relating to acquisitions or restructuring transactions, as well as any ordinary business loans to, or investments in, the same obligor. Total exposure also includes standby letters of credit, legally binding contractual commitments, and other financial guarantees.

- Loans or exposures to any obligor in which the total financing package (including extensions of credit by all participants) did not exceed $5 million at the time of origination may be excluded from the definition of HLFs.

- These guidelines are not meant to suggest that loans or exposures meeting the HLF definition should necessarily be criticized or deemed to involve excessive risks. Nor is the 75 percent debt-to-assets benchmark intended to reflect what is considered high or abnormal leverage in all industries. Rather, the definition is intended to provide guidance to examiners for identifying in the first instance certain exposures that may warrant further scrutiny and to do so on a consistent basis across banking organizations. The analysis of a borrower's financial position should take account of both the absolute level of the borrower's leverage ratio, as well as how the borrower's leverage compares to conditions and norms within the particular industry. Any criticism of exposures stemming from HLFs, like all other credits, should be based on the examiner's evaluation of all relevant credit factors, as well as on the guidelines set forth below.

Policies and procedures

- Examiners should review an organization's policies and procedures to ensure that: i) credit evaluation involves an independent assessment of the adequacy of the borrower's current cash flow and collateral values and the projected values under varying economic and interest rate assumptions, including the possibility of an economic decline; ii) the organization has established reasonable "in-house" limits regarding exposure to individual borrowers, total exposure to all HLF borrowers, and industry concentrations; iii) credit decisions on significant HLFs are made and monitored at appropriate senior management levels; iv) management reporting systems and controls are adequate to monitor the condition of individual HLF borrowers, as well as the organization's compliance with internal policies and lending limits; and v) timely and adequate reports are provided to senior management and boards of directors regarding the performance of significant HLF exposures and the organization's overall involvement in this activity.

- Credit standards and pricing policies should be reviewed to determine that they incorporate consideration of the tradeoff between risk and return.

- Each holding company subsidiary should establish appropriate credit review and approval procedures that call for a complete and independent assessment of loans or investments to be made by the subsidiary. Review and approval standards regarding mezzanine financing and equity positions should take account of the particular risks associated with these activities.

- "In-house" limits should be based on consolidated holding company exposure and take account of all extensions of credit, as well as holdings of debt and equity securities issued by HLF obligors. In addition, appropriate exposure limits should also be established for each subsidiary engaged in any aspect of an HLF. When a single HLF transaction involves loans or exposures to legally separate but related obligors, the exposures should be combined for determining compliance with internal exposure limits.

- Examiners should review the banking organization's internal guidelines or practices on what is considered to be an acceptable minimum level of: i) borrower cash flow in relation to debt service and fixed charge requirements; and ii) collateral protection.

- A banking organization's internal credit review and approval procedures should call for an evaluation of the continuity and experience of the borrower's management.

- Examiners should determine that all income, fees and commissions relating to HLFs are properly identified and recognized in accordance with generally accepted accounting principles. Internal reporting systems should monitor the amount and treatment of fees associated with HLFs.

- Examiners should ascertain whether banking organizations purchasing participations in HLFs apply the same standards of prudence, credit assessment and approval criteria, and "in-house" limits that would be employed if the purchasing organization were originating the loan. Examiners should also ensure that the purchasing institution obtains from the lead lender copies of all executed or proposed loan documents, legal opinions, title insurance policies, UCC searches and other relevant documents. The purchase of participations in HLFs originated by other banks should involve a full and independent credit review by the purchasing organization. Organizations holding participations should obtain adequate and timely information on the borrower and closely monitor the borrower's performance throughout the entire life of the exposure.

- Sales of participations in HLFs should be made on a non-recourse basis. Approval procedures and exposure or position limits should apply to any purchases of HLF loans as part of trading or market-making activities. Such purchases should be segregated in a separate trading account and be reported at the current market value, or the lower of cost or market value.

- A banking organization's policies and procedures should provide for legal review of involvement in HLFs to determine that the activities are consistent with applicable laws and regulations and that they are conducted in a manner that addresses the potential for conflicts of interest. Policies and procedures regarding loans to borrowers whose obligations are being underwritten by an affiliated securities firm should be carefully reviewed to determine compliance with the prudential framework set forth in the Board's Section 20 orders. Among other things, this framework requires the banking organization to establish appropriate limits for the consolidated holding company's overall exposure to any single underwriting client of a securities affiliate. Policies should also address the risks associated with equitable subordination. Examiners should determine whether the banking organization has a comprehensive documentation policy addressing the primary legal risk of fraudulent conveyance in LBO transactions.

- Major policies and procedures, including internal credit review and approval procedures and "in-house" exposure limits, should be reviewed periodically and approved by the board of directors.

Other examination considerations

- In evaluating individual loans and credit files, particular attention should be addressed to i) the overall performance and profitability of the industry over time, including during periods of economic or financial adversity; ii) the history and stability of the borrower's market share, earnings and cash flow, particularly over the most recent business cycle and the last economic downturn; iii) the reasonableness of earnings and cash flow projections; iv) the relationship between the borrowing company's projected cash flow and debt service requirements and the resulting margin of debt service coverage; and v) the reliability and stability of collateral values, including their sensitivity to varying economic scenarios, and the adequacy of collateral coverage.

- Particular attention should be paid to the adequacy of a borrower's cash flow. Banking organizations should make an independent and realistic assessment of the borrower's cash flow projections under varying economic and interest rate assumptions and be able to demonstrate that they have taken into account the potential effects of an economic downturn on a borrower's cash flow and collateral values before becoming involved in an HLT.

- A loan whose repayment is not predicated upon an identifiable and historically stable source of cash flow bears speculative qualities. Reliance for loan repayment on the sale of assets or subsidiaries whose values are not clearly supported by i) an historically demonstrated ability to produce adequate cash flow, ii) a firm sales contract or "take-out" commitment, or iii) a realistic cash-generating capacity based upon current economic conditions, is an inappropriate banking practice that could expose a bank to undue risks. Such loans should receive careful supervisory scrutiny and, under normal circumstances, should be subject to examiner comment or criticism. Ordinarily, unless conservatively projected cash inflows provide a reasonable margin above the total debt service requirements and other fixed expenditures of the borrower, classification of the credit is appropriate.

- When the proceeds of asset sales play an important role in reducing the debt, the methods used to determine asset valuations and projected sale proceeds should be carefully scrutinized. In addition, asset collateral coverage should be reassessed periodically throughout the life of the debt, and actual sales proceeds should be compared to projections made at origination of the HLF in order to monitor the reasonableness of the lender's assumptions concerning valuations.

- Repayment programs should specify the sources and timing of repayment, and any significant deviations from the programs should be evaluated.

- The amount of senior debt in relation to total financing should be carefully reviewed. In general, a bank's risk can be reduced if its position is senior to all other levels of debt and secured by a first lien on assets or all the stock of the borrower's operating entities. Ideally, the debt structure should permit the borrower to suspend payments on junior debt should circumstances so warrant.

- Special attention should be given to the risks associated with short-term bridge financing in connection with highly-leveraged restructurings. Such risks may be greater than normal because these loans are typically subordinated to other debt, may not be collateralized, and depend on the successful marketing of longer term securities or the sale of assets for repayment.

- Because of potential conflicts of interest that may affect lending practices, examiners should carefully review any loans and related documentation involving borrowers whose obligations are being underwritten by a securities affiliate.

- Examiners should determine the extent to which borrowers are protected from interest rate increases via interest rate caps or other hedging mechanisms. Generally, long-term loans to HLF obligors should involve some measure of protection for the borrower against increases in interest rates.

- In addition to reviewing the total volume of a banking organization's HLFs, examiners should assess the extent to which the organization's income comprises fees and commissions relating to HLFs. Examiners should also take account of the extent to which income is composed of gains on the sale of equity holdings.

- In addition to equity positions relating to particular HLFs, examiners should determine the extent of the banking organization's involvement in LBO funds.

- Examiners should review the timeliness and quality of reports to senior management and directors. Reports should address the performance of HLF obligors, the quality of the HLF portfolio, and the condition of the organization's overall HLF activities.

- Total HLF exposure should be treated as a potential concentration of credit and if, in the aggregate, it is sufficiently large in relation to capital, the total HLF exposure and a listing of the major HLF obligors should be included on the concentrations page in the examination report. A brief comment should describe the composition of these exposures (i.e., breakdown by number, outstandings, unused commitments, industry involvement, type and level of total criticized).

- If HLFs are not considered to be a concentration of credit, but are still considered a significant activity, the total exposure and the other information described in the previous item should be set forth in the confidential section of the examination or inspection report.

Chairman **Rostenkowski**. Mr. David Walker. It is the intention of the committee to stay in session through lunch, so the panels will be convened immediately after Mr. Walker's testimony, and we will take testimony right through lunch.

Welcome to the committee, Mr. Walker. It is a pleasure to have you here to help us in the solution to some of these problems if there indeed is a solution. The committee is ready to take your testimony if you will proceed.

STATEMENT OF HON. DAVID M. WALKER, ASSISTANT SECRETARY FOR PENSION AND WELFARE BENEFITS, U.S. DEPARTMENT OF LABOR

Mr. **Walker**. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I am very pleased to be with you here this afternoon to discuss the views of the Department of Labor concerning certain ERISA issues related to leveraged buyouts and corporate takeovers.

I would like to request my written statement, specifying in detail ERISA's requirements, be entered into the record.

Private pension plans currently hold approximately 18 percent of total U.S. corporate equities and 26 percent of total U.S. corporate debt. Equity holdings constitute approximately 36 percent of private pension plan assets, and corporate debt holdings constitute about 27 percent of private plan assets. As a result, private pension plans have become major factors in our Nation's capital markets and participants in certain leveraged buyouts and corporate takeover battles.

Recently there has been increased public attention accorded to pension plan investments in leveraged buyout funds and noninvestment grants, so-called junk bonds, issued by those engaged in leveraged buyouts. Questions have been raised as to the appropriateness of such investments by pension plans. Although some pension plans had participated in these transactions as investors, detailed information about the degree of their participation is somewhat limited. However, based upon available information, we estimate that less than 2 percent of total private pension plan assets are invested in high-yield, noninvestment grade so-called junk bonds and leveraged buyout limited partnerships. In addition, we know of no individual defined benefit pension plan that has a significant portion of its assets invested in such instruments.

Under current law, there is nothing in ERISA that precludes such investment if they are otherwise consistent with ERISA's requirements that investments be made solely in the interest of plan participants and be prudent and diversified so as to minimize the risk of large losses. Consistent with these rules, before making such investments in junk bonds or leveraged buyout funds, a plan fiduciary must determine whether or not it is capable of bearing any increased risk and reduced liquidity associated with making such investments, keeping in mind ERISA's requirement that plan fiduciaries must diversify plan investment so as to minimize the risk of large losses.

They must also evaluate whether the increased return adequately compensates the plan for the increased risk which it bears in making such an investment. The ability of a plan fiduciary to diversify and to pursue different investment strategies is important in maintaining the stability and security of a pension fund. ERISA allows investments in high-risk vehicles such as venture capital, certain forms of real estate, junk bonds or LBO funds as part of a plan's overall investment strategy.

Through a broad-based diversified portfolio, it is possible for a pension plan to simultaneously take advantage of economic growth while protecting against losses in times of recession, helping to ensure the long-term stability and security of the fund.

The legal environment that ERISA created allows a plan fiduciary a great degree of discretion in structuring plan investments, provided that the investments are economically prudent and diversified so as to minimize the risk of large losses.

From the evidence we have been able to gather, this structure appears to be working well. We recognize that takeover and LBO-related investments have burgeoned in the last few years and that most of them have not been tested by a full business cycle. We will, therefore, continue to monitor the situation to determine what, if any, actions may be appropriate.

In the meantime, it is the Department's view that applying special rules to particular types of pension fund investments or singling out private pension fund investments for selective treatment with respect to investment activity compared to that of other institutional investors could adversely affect the long-term health of pension plans and have significant consequences for the security of our retirement system.

In addition to private pension plan investments in leveraged buyout and takeover related instruments, questions have been raised regarding ERISA's requirements relating to tender offer decisions for shares of stock held in the plan. Tender offers require pension plan fiduciaries to make an investment decision, namely whether to hold, tender or sell into the market.

Some have asserted that ERISA requires pension plan fiduciaries to automatically take any premium over the prevailing market price irrespective of what they feel the longer term prospects of that investment might be. This is not correct. It is the Department's view that plans are not required to take the so-called quick buck if, based upon an appropriate and objective analysis, it is reasonable to anticipate that they will receive a higher economic value by holding the investment than by tendering or selling into the market and reinvesting the proceeds.

At the same time, in those situations where the plan fiduciary is considering whether or not to tender shares, where the plan sponsor is the target of a corporate takeover attempt, the fiduciary must be especially cautious to ensure that its decision is based on what is in the ultimate economic interest of the plan as a separate and distinct legal entity established for the purpose of providing retirement income and security.

In this regard, it should be noted fiduciaries must be alert to and resist any attempts by corporate management to use the assets of their own plans either as offensive or defensive tools in takeover battles. The Department has spoken out on this issue and has brought related litigation when we have found that ERISA rules have been violated.

In summary, the Department will continue to evaluate the many issues and implications of pension plan involvement in takeovers and buyouts and to monitor the situation to determine what, if any, additional actions or recommendations may be appropriate.

I thank you again for the opportunity to testify, Mr. Chairman. I would be pleased to answer any questions that you might have or any other members of the committee.

[The statement of David M. Walker follows:]

STATEMENT OF
DAVID M. WALKER, CPA
ASSISTANT SECRETARY FOR PENSION AND WELFARE BENEFITS
U.S. DEPARTMENT OF LABOR
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

February 2, 1989

I. INTRODUCTION

Mr. Chairman and members of the Committee, my name is David Walker. I am the Assistant Secretary of Labor for Pension and Welfare Benefits.

I am pleased to appear before you today to discuss the views of the Department of Labor concerning certain ERISA issues relating to leveraged buyouts and corporate takeovers. Obviously, the issues raised by leveraged buyouts and takeovers in general are much broader than those raised by the participation of pension plans in such transactions. Our testimony, however, will focus primarily on the role of pension plans in such transactions.

The Department of Labor (the Department) has responsibility for the administration and enforcement of Title I of the Employee Retirement Income Security Act of 1974 (ERISA), governing the regulation of private employee benefit plans. There are approximately 41.9 million workers covered by 870,000 private pension plans and 65 million workers covered by 4.5 million private welfare benefit plans. Therefore, the Department has a strong interest in issues related to employee pension and welfare benefit plans, and is especially interested in assuring that such plans are properly managed in accordance with the fiduciary responsibility provisions of Part 4 of Title I of ERISA.

Because of the size and growth of pension plan assets over the past 15 years, pension plans play an ever increasing role in the capital markets. Private pension plans currently hold approximately 18 percent of total corporate equity and 26 percent of total corporate debt. Equity holdings constitute approximately 36 percent of private pension plan assets, and corporate debt holdings constitute about 27 percent of private plan assets. As a result, they have become major participants in certain leveraged buyouts and corporate takeover battles. Although some pension plans have participated in these transactions as investors, our information about the degree of their participation is limited. We estimate that less than 2 percent of total pension plan assets is invested in high yield, non-investment grade bonds (so-called "junk bonds") and leveraged buyout limited partnerships. In addition, we know of no individual private defined benefit plan that has a significant portion of their assets in such investments.

There are those who are concerned that any changes in existing laws that would affect the participation of pension plans in the capital markets could have a potentially adverse effect on the overall funding of pension plans and on the retirement income security of American workers and retirees. We hope that this opportunity to state the views and experience of the Department on these important issues will be helpful.

Pension funds may be affected by leveraged buyouts in two respects. First, pension funds may be affected in their capacity as investors of assets held in trust for the plan participants. Secondly, a pension fund's stability may be affected by a takeover of its plan sponsor in a leveraged buyout. We understand that the Pension Benefit Guaranty Corporation has testified concerning the effect on plan stability of takeovers of plan sponsors in leveraged buyout situations. Our discussion, therefore, will focus on ERISA's requirements for pension funds as investors.

Before discussing the Department's views concerning various aspects of pension plan participation in leveraged buyouts and takeovers in particular, I would like to discuss ERISA's general fiduciary responsibility requirements relating to all plan investments.

II. BACKGROUND

The investment of plan assets is subject to the fiduciary responsibility rules of Title I of ERISA. These rules provide, among other things, that plan fiduciaries (which include those individuals or entities who exercise discretionary authority or control over the management of plan assets) must act with the care, skill, prudence and diligence that a prudent person acting in a like capacity and familiar with such matters would use. ERISA requires that plan assets be used solely in the interest of the participants and beneficiaries of such plans, and for the exclusive purpose of either paying benefits or defraying reasonable expenses of administering the plan. ERISA also generally requires that plan assets be diversified so as to minimize the risk of large losses.

All decisions concerning plan investments, including investments related to leveraged buyout and corporate takeover activity, must be judged under ERISA's prudence, exclusive purpose, and, where applicable, diversification rules. Therefore, fiduciaries of a pension plan covered under ERISA must ensure that their decisions are based on what is in the best economic interest of the plan as a separate and distinct legal entity designed to provide retirement income and security. It is the Department's view that, while ERISA does not direct fiduciaries to make particular investment decisions, it does require plan fiduciaries to consider the economic merits of each investment and to determine whether, based on the plan's portfolio and its particular needs, the investment provides the return consistent with the financial risk involved. Moreover, pension plan fiduciaries have an ongoing responsibility to monitor the performance of the underlying investment.

Having introduced these basic concepts, I would now like to address pension plan involvement in leveraged buyouts and corporate takeovers.

III. PENSION PLAN INVOLVEMENT IN LEVERAGED BUYOUTS AND TAKEOVERS

Given the size and projected growth of pension plan assets, pension plans are inevitably involved as major participants in takeover battles. Plan fiduciaries are called upon to make decisions with respect to tender offers for shares of stock held in the pension funds' portfolios whenever there is a leveraged buyout or a tender offer. In constructing a portfolio appropriate for the plan, pension plan fiduciaries may be required to decide the appropriateness of their plan participating directly in a leveraged buyout, participating indirectly, through purchase of a limited partnership interest in a leveraged buyout fund, or investing in debt issued by entities engaged in leveraged buyouts.

Whether the issue is investment of plan assets in leveraged buyout limited partnerships or in high yield, non-investment grade bonds (so called "junk bonds"); voting proxies of stock held by plans in takeover situations; or deciding whether or not to tender stock held by the plan during a hostile takeover, fiduciaries of ERISA covered plans must ensure that their actions are consistent with ERISA's fiduciary responsibility requirements.

I would now like to address the ERISA implications of plan involvement in leveraged buyouts and various types of corporate takeover activities.

IV. ERISA IMPLICATIONS OF PENSION PLAN INVOLVEMENT IN LEVERAGED BUYOUTS AND TAKEOVERS

INVESTMENT OF PLAN ASSETS IN LEVERAGED BUYOUT LIMITED PARTNERSHIP FUNDS AND SO CALLED "JUNK BONDS"

Recently, there has been increased public attention accorded to the investment of pension plans in leveraged buyout funds and non-investment grade bonds issued by entities engaged in leveraged buyouts. Questions have been raised as to the appropriateness of such investments by pension plans.

There is nothing in ERISA that precludes such investments if they are otherwise consistent with ERISA's requirements that investments be made solely in the interest of plan participants and beneficiaries, be prudent, and be diversified so as to minimize the risk of large losses. Consistent with these rules, before making any investments in junk bonds or in leveraged buyout funds, a plan fiduciary must determine whether or not its plan is capable of bearing any increased risk associated with making such investments, keeping in mind ERISA's requirement that plan fiduciaries must diversify plan investments so as to minimize the risk of large losses, and must evaluate whether the increased return to the plan adequately compensates the plan for the increased risks which it bears in making such an investment.

The ability of a plan fiduciary to diversify, and to pursue different investment strategies, is important in maintaining the stability and security of a pension fund. ERISA allows investments in high risk vehicles, such as venture capital, real estate, or junk bonds, as part of an overall investment strategy. Through a broad-based, diversified portfolio, it is possible for a pension plan to simultaneously take advantage of economic growth while protecting against losses in times of recession, ensuring overall long term fund stability.

The legal environment that ERISA created allows a plan fiduciary a great degree of discretion in structuring plan investments, provided that the investments are economically prudent and diversified so as to minimize the risk of large losses. From the evidence we have been able to gather, this structure appears to be working well. We recognize that these types of investments have burgeoned in the last few years and that they have not been tested by a full business cycle. We obviously will continue to monitor the situation to determine what, if any, actions may be appropriate. It is the Department's view, however, that applying special rules to particular types of pension fund investments or singling out pension fund investments for selective treatment with respect to investment activity compared to that of other institutional investors, could adversely affect the long term health of pension plans, and have significant consequences for the security of our retirement system.

TENDER OFFERS

Tender offers represent investment decisions. Thus, when a plan fiduciary is considering whether or not to tender shares in a situation where the plan sponsor is the target of a takeover attempt, the fiduciary must ensure that its decision is based on what is in the economic interest of the plan, as a separate and distinct legal entity established for the purpose of providing retirement income and security. In this regard, it should be noted that fiduciaries must be alert to, and resist, any attempts by corporate management to use the assets of their own plans either as offensive or defensive tools in takeover battles. The Department has spoken out on this issue and brought related litigation when we have found that ERISA's rules have been violated.

ERISA does not mandate that plan fiduciaries must automatically tender shares held by the plan in order to capture any premium represented by the tender offer. Plans are not required to tender their shares if, based upon a thorough and objective analysis, it is reasonable to anticipate that they will achieve a higher economic value by holding the investment than by tendering and re-investing the proceeds.

The Department takes no general position as to whether fiduciaries should or should not tender shares, or whether they should vote for or against management. However, it is the Department's view that ERISA requires fiduciaries to make individual investment decisions based on the facts and circumstance applicable to the investment and the plan.

V. ERISA PLANS AND LONG TERM INVESTMENT

It has been argued that the threat of hostile tender offers often leads corporate management to try to satisfy short-term demands of the market at the expense of investing in long term projects such as research and development. It is also argued by some that the investment behavior of pension plans facilitates hostile tender offers because these plans are willing to tender their shares to any bidder offering even a small premium over market price. We know of no empirical evidence that pension plans covered by ERISA are acting in any different manner than non-ERISA covered pension plans or other institutional investors who may be expected to take a long term outlook. As I have stated before, ERISA's prudence requirement essentially states that what is economically prudent for the plan is legally prudent. It is the Department's view that plans are not required to take the "quick buck" if, based upon a thorough, and objective, analysis, it is reasonable to anticipate that they will achieve higher economic value by holding the investment than by tendering or selling into the market and re-investing the proceeds.

VI. CONCLUSION

The security, stability, proper funding and credibility of our private pension system must be assured. The Department will continue to vigorously enforce ERISA's requirements that plan investments are made on the basis of what is in the best economic interest of the plan participants. We will also continue to evaluate the many issues and implications of pension plan involvement in takeovers and leveraged buyouts to determine what, if any, additional actions or recommendations may be appropriate.

Mr. FORD [presiding]. Thank you very much, Mr. Walker.

Does the Department have any plans to monitor the overall asset performance or plans with extensive investments in LBO's?

Mr. WALKER. We will continue to monitor the overall investment activity by private pension plans in these areas. We do that primarily through our normal ongoing investigations of plans to assure that their investments are prudent and diversified, and to review for any potential conflicts of interest.

As I mentioned, Mr. Chairman, at present time private pension plan investments in these type instruments constitute less than 2 percent of total private pension plan assets, and, therefore, we don't see a need for a special emphasis, if you will, on these instruments at the present point in time.

Mr. FORD. Is the Department of Labor studying the possibility of developing recommended limits on the percentage of assets invested in LBO's or any other type of high-risk investments?

Mr. WALKER. Mr. Chairman, at the present time we do not feel that—given: the current limited extent of pension plan investments; the other protections that are accorded in ERISA, the need for diversification and prudence; and the recent changes in law that were made and which this committee was very instrumental in helping us to achieve as part of the Pension Protection Act—it does not appear to be necessary or appropriate to place any restrictions on the ability of pension plans to invest in these types of investment vehicles. Any such restrictions might set adverse precedents or implications for other forms of investments that involve higher degrees of risk, such as venture capital and other forms of investments that can benefit plans and our economy.

Mr. FORD. The Department of Labor and the Department of Treasury recently issued a joint statement clarifying the pension fund managers are not legally required to sell shares in response to the above market price tender offer—I think you just made mention of that, rather they can take long-term considerations into account.

What do you think the pension fund managers' response to these guidelines will be?

Mr. WALKER. Well, it is difficult to determine. Our purpose for issuing that joint statement was to clear up any misperceptions that ERISA, as a matter of law, automatically mandated that pension plan fiduciaries must accept any premium above the prevailing market price irrespective of what they thought the long-term consequences were. Therefore, to the extent that the pension plan fiduciaries were confused as to whether or not the law would allow them to hold if they felt that the ultimate economic return to the plan might be better, it could have an effect.

Our key here was not to dictate that people should or should not tender or to take a position on that, but rather to clear up any area of uncertainty that might exist, such that they didn't feel artificially constrained by the law to take a myopic or short-sighted approach.

Mr. FORD. Thank you very much.

Mr. MOODY. Thank you, Mr. Chairman.

You said less than 2 percent of LBO action is using pension fund money. Is that correct?

Mr. **Walker**. Less than 2 percent of private pension assets are in two types of LBO related investment vehicles, so-called junk bonds and leveraged buyout limited partnerships. I think it is important to note, Congressman Moody, that as the recent GAO study noted in early 1988, about half of so-called junk bond activity has nothing to do with the takeovers or leveraged buyouts.

Mr. **Moody**. So the 2 percent includes either junk bond or leveraged buyouts?

Mr. **Walker**. That is correct, both.

Mr. **Moody**. But we were told, I guess 2 days ago, that 12 percent of LBO activity was in fact using pension funds. So this is a different way of looking at the number, is that correct?

Mr. **Walker**. Well, there are two ways to look at the numbers. One, of all of the LBO activity, for example, of the total amount of junk bonds or the total amount of capital in leveraged buyout limited partnership funds, what percentage is attributable to pension funds? And those numbers range from 10 to 15, although those numbers include public pension plans, as well, which have tended to be more aggressive in this area than private pension funds, and we do not regulate public pension funds. The 2 percent number that I gave is in relation to total private pension assets which total about $1.7 trillion.

Mr. **Moody**. Ten to fifteen percent, whether you regulate or you're the public, that tends to be a significant amount of money, and a significant proportion of the action.

Mr. **Walker**. Two percent of private pension assets is $34 billion.

Mr. **Moody**. But 15 percent of the LBO action——

Mr. **Walker**. Should be about the same.

Mr. **Moody**. In terms of the issue we are looking at, it is not a negligible or trivial amount of the action?

Mr. **Walker**. No, it isn't, but it also means that anywhere from 85 to 90 percent of the financing has nothing to do with private pension plans.

Mr. **Moody**. I understand.

You mentioned in the latter part of your testimony you wanted to clarify there was no requirement that the managers go for these premium ownerships, what someone called ownership premiums. Isn't the problem also one possibly that investment houses or other people managing or holding in street name some of these shares, might actually have a kind of ongoing conflict of interest in the other direction, namely they may have certain inducements or incentives to protect management and vote the proxies with management?

I guess I am getting at a possible conflict of interest issue here, because they are back and forth in management on so many issues, including the need to raise capital, and so forth, and management turns to the street. Insofar as people on the street, even though they might be separate departments of a given investment house managing the funds that they use to raise funds for, a closer relationship that might develop between management of the target company and those managing pension funds may induce those pension fund managers to in fact vote with management when in fact the pensioners might be better served if they didn't vote or had an open mind and independent view on it. You see what I am getting at?

Mr. WALKER. I very much see what you are getting at.

Mr. MOODY. In other words, the reverse problem of having jumped at the highest price. It may be too slow to go for a higher price?

Mr. WALKER. The Department has spoken out extensively on corporate governance related issues, which includes proxy voting, including the obligations of pension plan fiduciaries to vote shares that could have an effect on the economic value of the stock in accordance with what is in interest of plan participants and beneficiaries, recognizing the plan as a separate legal entity designed for the purpose of providing retirement income. That means in certain situations they might vote for management, in others, against.

We, in our enforcement activities, try to focus on potential conflicting interests, and that is an area, along with the need for diversification that would be the focus of enforcement activities in this area.

Mr. MOODY. This is the so-called Avon letter?

Mr. WALKER. The so-called Avon letter.

Mr. MOODY. Where does it stand? The Avon letter was a shot across the bow of the industry. Where does that stand now? To where has that been carried, are there follow-up actions, and are there institutions on the street that actually can say with a clear conscience, "We have no conflict of interest, there is not another division of our outfit which is in fact dealing with that same management, we are not asked to vote against it"? Do you see what I am saying? Are there entities out there saying, "We have no other dealings with Company X except managing the pension fund"?

Mr. WALKER. It all depends upon who has the responsibility for voting the proxies under the plan. In most instances, it is the investment manager who also has the responsibility for making the buy and sell decision. With regard to where we stand, we issued guidance as to what ERISA's requirements are with regard to proxy voting in the so-called Avon letter. Subsequently, we announced a limited enforcement review project in which we looked at a number of contested proxy issues and tried to analyze whether or not there might have been any violations of law, and whether or not we might need to provide additional guidance to the investment community.

That limited enforcement review has recently been completed. It should be coming to me within the next few weeks, and we will determine what, if any, additional action or guidance we might provide in advance of the proxy voting season that is coming up.

[The following was subsequently submitted by Mr. Moody:]

JIM MOODY
WISCONSIN

COMMITTEE ON
WAYS AND MEANS

Congress of the United States
House of Representatives
Washington, DC 20515

1019 Longworth Building
Washington, DC 20515
(202) 225-3571

135 West Wells St.
Room 618
Milwaukee, WI 53203
(414) 291-1331

February 23, 1989

The Honorable David M. Walker
Assistant Secretary for
Pension Benefits and Welfare Administration
200 Constitution Avenue
Room S2524
Washington, D.C. 20210

Dear Mr. Assistant Secretary:

This letter is to follow up our phone conversation yesterday about the conflict of interest potential when pension fund corporate shares are voted in a hostile takeover situation.

You'll remember that we discussed this at the Committee hearings three weeks ago and by now you should have a copy of your February 2 testimony, including your assurance to me that the enforcement guidelines would be available within a few weeks from then. Thank you for your phone assurance that they will be ready very soon.

Many of us are anxious to see the Department's policy directive on this matter issued in time to provide guidance for the proxy season, which is about to start. This whole situation presents a very serious conflict of interest potential, and it is urgent that DOL provide the leadership on a timely basis.

As I mentioned on the phone, I would be interested in reading whatever draft exists right now so that we could discuss these issues at your earliest convenience.

I have informed the Committee that I will be placing the completed enforcement guidelines in the official hearing record, and we await that with interest.

Meanwhile, let me know if I can be of help.

Sincerely,

Jim

Jim Moody
Member of Congress

U.S. Department of Labor

Assistant Secretary for
Pension and Welfare Benefits
Washington, D.C. 20210

March 2, 1989

The Honorable Jim Moody
U.S. House of Representatives
1721 Longworth House Office Bldg.
Washington, D.C. 20515-4905

Dear Congressman Moody:

As we discussed by telephone, enclosed is a copy of the press release and proxy report. If you have any questions or would like to discuss the report, I am available to meet with you at your convenience. Please call my office at 523-8233 to schedule an appropriate time.

Sincerely,

Dave Walker
DAVID M. WALKER
Assistant Secretary

Enclosure

PROXY PROJECT REPORT

Pension and Welfare Benefits Administration

U. S. Department of Labor

March 2, 1989

PROXY PROJECT REPORT

I. BACKGROUND

As of the end of 1987, private pension plans owned approximately $537 billion of stock, or 18%, of all equity securities in United States corporations and much larger percentages of many of the nation's largest corporations. They represent the largest single and fastest growing category of institutional investors. The Department estimates that by the year 2000 employee benefit plans (public and private) will own approximately 40% of all U.S. corporate equities. The actions of pension fund investment managers and trustees, in buying and selling shares of stock and in exercising their rights as shareholders, can have a significant effect on the securities marketplace, corporate management, and the determination of contests for corporate control. In fact, pension plans are becoming a major factor in proxy voting contests and takeover battles.

In the past, institutional investors, including pension plans, have taken a somewhat passive role on matters concerning corporate governance. American Bankers Association guidelines developed in the 1940s suggested that banks should normally vote with management, the theory being that a vote contrary to management shows no confidence in management's conduct of business. This became known as the "Wall Street Rule".[1] In practice it meant that institutions had confidence in and supported management by voting their shares in favor of management supported issues or else sold the stock.

Many believe that the "Wall Street Rule" is no longer viable due, among other things, to the rapid growth of pension fund assets under institutional management. They note that the large blocks of stock owned by major institutional investors may not be disposed of easily. Thus, a major institutional investor holding a large block of stock in a particular corporation may have to liquidate its holdings over an extended period of time to avoid adversely affecting its price or otherwise incurring prohibitive liquidation costs. They also assert that a widespread following of the "Wall Street Rule" by all institutional investors could have the effect of decreasing stock prices, increasing overall market volatility and transaction costs, and reducing corporate accountability to shareholders. Also, the enactment of the Employee Retirement Income Security Act in 1974 (ERISA) established federal fiduciary standards that have heightened awareness by fiduciaries and investment managers to employee benefit plans of their duties to plan participants and beneficiaries.

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[1] Pension Funds and Corporate Governance, a report to the U.S. Department of Labor, PWBA, by the Investor Responsibility Research Center, June 1985, Part III, p. 54.

The Pension and Welfare Benefits Administration (PWBA) of the Department of Labor (the Department) has responsibility for administration and enforcement of Title I of ERISA. Title I of ERISA establishes standards governing the operation of employee benefit plans and the conduct of fiduciaries with respect to such plans. In December 1986, PWBA instituted a new enforcement strategy under which 50% of its investigative resources are concentrated on certain issue oriented areas designated as "Significant Issues". Currently, one of these issues concerns management of pension fund assets by financial institutions including investment managers, banks, insurance companies, and other similar organizations with discretionary responsibility over employee benefit pension plan assets.

In February 1988, the Department issued a letter concluding an investigation in which the Department apprised the subject fiduciaries of its views and the possibility of ongoing violations regarding the responsibility of investment managers and plan sponsors in voting proxies.[3]

Specifically, this letter was intended to advise plan fiduciaries and other interested parties of the Department's views concerning the general fiduciary obligations of a named fiduciary and an investment manager appointed pursuant to Section 402(c)(3) of ERISA with respect to the voting of stock held by employee benefit plans. The letter outlined the applicable sections of ERISA which designate or allocate fiduciary responsibilities to investment managers and how that relates to proxy voting by investment managers. In particular, the letter explains that the named fiduciaries of a plan may appoint investment managers as defined under Section 3(38) and, thus, generally relieve the named fiduciary of liability for decisions of the investment managers. However, once the delegation is made, the investment manager is responsible for delegated decisions and may not take direction from others with respect to these matters. The letter states that, in general, the management of corporate stocks in the plan's portfolio of assets includes the voting of proxies for those shares unless reserved to the plan trustee by the appointing named fiduciary. Thus, it is the Department's position that the decision as to how proxies should be voted with regard to the issues that might affect the economic value of the underlying securities is a fiduciary act of plan asset management.

In May 1988, PWBA announced the initiation of a limited enforcement review project to monitor how investment managers with control over employee benefit plan assets subject to ERISA are exercising their fiduciary responsibility in voting stock owned by the plans whose assets they manage. A news release was issued at the beginning of the enforcement project.[3] PWBA's purpose was to obtain an understanding of the level of general compliance with the ERISA provisions discussed in the letter. As a result, PWBA chose to review the management of plan votes from a broad range of investment managers rather than from an in-depth case inquiry. In particular, PWBA sought to determine whether and by what process investment managers, including banks functioning as investment managers, are discharging their responsibilities with respect to voting of stock with a particular focus on certain contested issues considered at annual shareholders' meetings in 1988.

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[3] The Department's letter is attached as Attachment A.

II. INVESTIGATIVE PROCESS

Proxy contests with respect to twenty-three (23)[4] companies were selected, all of which had one or more of the following proxy issues:

Anti-poison pill proposals	Considered by 12
Anti-greenmail proposals	Considered by 2
Confidential voting proposals	Considered by 7
Shareholder access to proxy statements	Considered by 5

The investment managers selected were responsible for employee benefit plan portfolios containing significant stock holdings in the 23 companies.

Five PWBA area offices participated in this project. They were the Boston Area Office; Chicago Area Office; Los Angeles Area Office; New York Area Office; and San Francisco Area Office.

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[3] See Attachment B.

[4] Allied-Signal, Inc., Amoco Corporation, Boise Cascade Corporation, Champion International Corporation, Champion Spark Plug Company, Chevron Corporation, Coleman Company, Inc., Gillette Company, Honeywell, Inc., International Paper Company, Kerr-McGee Corporation, Lockheed Corporation, Martin Marietta Corporation, Media General, Inc., Mobil Corporation, Pitney Bowes, Inc., Santa Fe Southern Pacific Corporation, Tenneco, Inc., Texaco, Inc., United Technologies Corporation, U.S. Air Group, Unocal Corporation, Upjohn Company. The selection of the proxy contests of these companies was based on their size and the issues presented and the likelihood that shares of stock in these companies would be held in pension plan portfolios. No negative inference should be drawn from the selection of proxy issues relating to these companies or from the selection of the respective investment managers.

It was determined that an initial letter of inquiry would be sent to the 120 selected investment managers. The letters requested that the responding firm provide written answers to the stated questions and/or provide documents which provided the information. If necessary or requested, the compulsory process of a subpoena would be used.

The area offices sent letters to the selected 120 investment managers regarding the organization's proxy voting processes.[3] The letters requested information on:

1. Allocation of responsibility between investment managers and other fiduciaries for voting proxies owned by the plan, and on what documentation the investment managers based their responsibility;

2. Identity of employee benefit plans holding stock (and number of shares) in each of the companies;

3. Whether and how the institution voted the stock;

4. The internal decision making process(es) used by the investment managers, including any policy guidelines on specific proxy issues such as poison pills, greenmail, etc.; and

5. Whether there was any communication between representatives of the respective employee benefit plans or plan sponsors and the investment managers or between the selected companies and the investment managers concerning the voting of proxies.

Although many of the entities requested subpoenas, none refused to produce documents. Documents received were reviewed in the area offices.

III. ANALYSIS

This project was not conducted based on a statistical method of selection of the investment managers or the proxy contests and, therefore, the conclusions that can be drawn from the responses may only reflect the group selected. However, several general observations appear to be evident as discussed below.

PWBA received 111 responses from investment managers who held shares in the targeted companies on behalf of approximately 4,860 employee benefit plans. (The remaining 9 did not hold stock at the time in the subject companies or did not manage employee benefit plans.) The responding investment managers collectively held approximately four percent of the outstanding shares of common stock in the 23 targeted companies.

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[3] See Attachment C for copy of letter.

A majority of the investment managers (61%) had voting responsibility and actually voted the proxies for the plans. The investment managers obtained voting responsibility in a variety of ways:

1. A standard or individual investment management agreement assigned or delegated them the responsibility.

2. The plan documents assigned the investment manager the responsibility.

3. The plan and trust documents and investment manager agreements were silent and the investment managers assumed the responsibility to vote as part of their general responsibilities as investment managers. This was the most common situation, occurring in 47% of the cases in which the investment manager voted proxies. Several relied on the terms in their investment management agreements that gave them investment responsibility that was "full discretion" and "full discretionary responsibility" to assume voting responsibility where their prototype investment management agreements were silent.

4. Although many investment managers responded that they received verbal authorization from their client(s) regarding voting the proxies, it was not determined whether they had sought such authorization. In one instance the responsibility for the investment manager to vote proxies was established at annual meetings with their client trustees. In another instance, the investment manager voted the proxies based on the verbal delegation from trustees even though trust agreements specifically grant trustee banks the voting responsibility.

In those cases where the investment managers reported they did not have voting responsibility (39%), based on the responses, PWBA could not positively determine in all instances who voted the proxies on behalf of the employee benefit plans. Some of the responses from the managers in this category were that:

1. Other fiduciaries, mostly trustees, are granted this responsibility.

2. As a matter of policy they do not vote proxies.

3. As a matter of policy, they do not vote on any controversial proxy issues; even if their client doesn't vote the proxies they will vote only the non-controversial issues.

4. The plan and trust documents and investment management agreements were silent and the investment managers assumed that they did not have the responsibility to vote proxies unless expressly delegated to them in writing or otherwise directed.

5. Upon request from clients they will make recommendations only.

Ninety-one (91) entities responded to questions on internal decision making procedures. Only six firms (of the 91) responded that they had no procedures in place. It appears that the larger investment management firms tended to have formal voting procedures. Of the responding investment managers, twenty-eight (28) investment managers reported having formal written procedures and they held approximately 64% of total ERISA assets under management in the universe of managers included in the project. Only three of the 28 firms had ERISA assets under management of less than $1 billion and the lowest dollar amount of ERISA assets under management in this category was $50 million. Some investment managers with informal voting procedures indicated there were no designated individual(s) within the organization who had specific responsibility for making decisions with respect to voting proxies.

PWBA also inquired as to whether written guidelines were used by the investment management firms for deciding how to vote proxies. The object was to determine if the firms had policies in place, either written or oral, for deciding how to vote proxy issues and then whether the investment managers followed their own policies in voting the proxies of the selected companies.

Responses concerning the written guidelines and procedures questions somewhat overlapped. Only thirteen investment managers reported a policy to vote for management, and only eight reported having no policies in place. Eighty-three percent (83%) of the investment managers surveyed reported having followed their stated proxy voting policies. Most exceptions concerned failure to vote proxies even though the investment manager had voting responsibility, or administrative error by the investment manager.

In one case, the investment management firm changed its vote as a result of discussions with its client, and two firms reported they supported management on anti-poison pill issues even though their general policy was to support these shareholder proposals. These firms described their reasons for voting contrary to their policy.

The last category of questions concerned contact by outside sources. As noted above, in one instance the investment manager was contacted by the plan sponsor and subsequently changed its vote on certain proxies. The vote, however, did not involve any proxy contests relating to the plan sponsor or any of its affiliates.

In addition, five investment managers reported contact by officials from a corporation involved in a proxy contest seeking support for management's position on the proxy issues. There is no indication that these contacts resulted in any deviation from the investment managers' stated policies.

A total of thirty-three investment managers reported recent changes in their proxy voting procedures and/or policies. One company stated that as a result of the Departmental "directions" within the past year, they are now incorporating language into all their investment management agreements to clearly designate voting responsibility. They have also instituted procedures to more carefully monitor receipt of proxy ballots, which had been a past problem. A number of other companies stated their investment management contracts are being revised to specifically provide for the investment manager to vote the proxies. In addition, a number of investment managers also stated that they are establishing internal procedures to record their actions in considering proxy votes and formalizing their policy positions on issues presented at shareholders meetings.

A common problem noted by PWBA during review of the responses has been the lack of accurate recordkeeping by the investment management firms. In one case, an investment manager did not know whether it had voted the proxies in question because no records were kept on proxy voting. In another instance, the investment manager indicated that he did vote proxies when forwarded by the custodian, but no attempt was made by the manager to determine if all the proxies had been received.

IV. CONCLUSIONS

The Department has stated its position that decisions on proxy voting are fiduciary acts of plan management, and are therefore subject to the fiduciary responsibility provisions of ERISA.

Sections 402, 403, 404, and 405, and 3(38) of ERISA contain the legal framework to designate or allocate fiduciary responsibilities to investment managers and to periodically monitor the activities of the investment manager with respect to the management of plan assets as follows:

Sections 402(a) and (b) require a written instrument which provides for one or more named fiduciaries who have responsibility to control and manage the operation and administration of the plan.

Section 405(c)(1) provides, in part, that the named fiduciaries may allocate fiduciary responsibilities or may designate other persons to carry out fiduciary responsibilities (other than trustee responsibilities) under the plan. Any allocation or designation procedure must be in writing in order to take advantage of the provisions of Section 405(c)(1).

There are two exceptions from the general rule of Section 403(a) -- that plan trustees have the exclusive authority and discretion to manage and control the assets of the plan. Section 403(a)(1) applies when the plan expressly provides that the trustee(s) are subject to the direction of a named fiduciary who is not a trustee, in which case the trustees are subject to proper directions of the fiduciary. The exception in Section 403(a)(2) applies when the responsibility to manage, acquire, or dispose of plan assets is delegated to one or more investment managers pursuant to Section 402(c)(3).

Section 402(c)(3) states a plan may appoint an investment manager(s) to manage plan assets. The term "investment manager" is defined in Section 3(38) of ERISA.

The relationship of proxy voting by properly designated investment managers follows the general principles concerning fiduciary responsibilities of managing plan assets. The normal course of management of plan assets which are corporate stock includes decisions with respect to voting proxies connected to those shares of stock. Therefore, it is the Department's view that the investment manager has the responsibility and related liability with respect to voting proxies, unless such responsibilities are specifically and properly reserved to the trustee.

Properly designated investment managers may not be passive on the issue of exercising proxy votes, even if plan and trust documents are silent to this effect. For example, investment managers may not, as a general policy, decline to vote proxies, or vote only non-controversial proxies. Nor may investment managers accept direction from others. Although contacts may, from time to time, occur from parties involved in proxy contests, the responsibility for the voting decision remains solely that of the investment managers. In this regard, the Department wishes to caution corporate officials who are also fiduciaries of the plan as to the conflicts of interest which may arise if they present the views of corporate management to the plan's investment manager on issues relating to the plan sponsor.

It should be emphasized that the responsibility for monitoring a properly designated investment manager rests with the named fiduciary who selected the manager. One of the problems noted from the responses was a lack of accurate recordkeeping by investment managers. Sections 405(c)(2) and 404(a)(1)(B) address the periodic monitoring of the activities of the investment managers by the named fiduciary who appointed the investment manager. In this regard, Section 404(a)(1)(B) requires proper documentation of the activities of the investment manager and of the named fiduciary of the plan in monitoring the activities of the investment manager. With respect to proxy voting, this requires the investment manager or other responsible fiduciary to keep accurate records as to the voting of proxies.

In the particular situations included in the inquiry, a number of the investment managers do not appear to have in place policies or procedures to assure that they are properly exercising the responsibility to vote proxies. Also, not all investment managers have in place specific procedures on voting of proxies, specific stated policies on how the manager would vote on certain issues, and adequate recordkeeping to document the proxy voting process.

Letters will be sent to those entities where it appears that the investment manager is not fully complying with its responsibilities, and those entities with lax or inaccurate recordkeeping.

PWBA will, as an on-going matter, continue to conduct inquiries as necessary in the area of responsibility of investment managers and trustees to vote proxies, document their reasons for such votes where significant and keep records as to voting and the conduct of this responsibility. Where appropriate, the Department of Labor will take enforcement related actions.

U.S. Department of Labor

Pension and Welfare Benefits Administration
Washington D C 20210

FEB 23 1988

Re: Employees' Retirement Plan

Dear

The Pension and Welfare Benefits Administration (PWBA) of the Department of Labor is responsible for administration and enforcement of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Title I establishes standards governing the operation of employee benefit plans and includes fiduciary responsibility rules governing the conduct of plan officials and others who exercise discretionary authority or control with respect to the assets of employee benefit plans, such as the Employees' Retirement Plan (the Plan), which are subject to ERISA.

PWBA has concluded its investigation of the Plan and of your activities as a fiduciary of the Plan, in connection with certain activities concerning the voting of proxies appurtenant to shares held in the accounts of the Plan's investment managers. The facts adduced during this investigation are not conclusive. However, because of the possibility that violations have occurred, and in view of the recurring nature of this aspect of plan asset management, we believe that it would be appropriate to apprise you of the Department's views concerning the general fiduciary obligations of a named fiduciary and an investment manager appointed pursuant to section 402(c)(3) of ERISA with respect to the voting of proxies on plan - owned stock. Since we expect that this information will be useful to the other members of the Plan's retirement board, and to the investment managers of the Plan, we are providing them with copies of this letter.

I. THE APPLICABLE PROVISIONS OF ERISA

Taken together, the provisions of ERISA sections 402, 403, 404 and 405 are intended to, among other things, provide a basis for certainty regarding the identity and responsibilities of those parties involved in managing and operating the plan, as well as each party's liability for mismanagement.

Attachment A

Section 402(a) of ERISA provides that every employee benefit plan shall be established and maintained pursuant to a written instrument. This instrument must provide for one or more named fiduciaries who have authority to control and manage the operation and administration of the plan. The named fiduciaries may be either named in the plan instrument or chosen, through a procedure specified in the plan, by the plan sponsor.

Section 402(b)(2) of ERISA requires plans to describe any procedure for allocating responsibilities for operation and administration of the plan, including any procedure described in section 405(c)(1).

Section 405(c)(1) of ERISA provides, in part, that the named fiduciaries may designate persons other than named fiduciaries to carry out fiduciary responsibilities (other than trustee responsibilities) under the plan. Section 405(c)(3) of ERISA defines "trustee responsibility" to mean any responsibility provided in the plan's trust instrument to manage or control the assets of the plan, other than a power under the trust instrument of a named fiduciary to appoint an investment manager in accordance with section 402(c)(3).

Section 403(a) of ERISA provides, in part, that all assets of an employee benefit plan must be held in trust by one or more trustees. The trustee(s) must have exclusive authority and discretion to manage and control such assets, with two exceptions: (1) when the plan expressly provides that the trustee(s) are subject to the direction of a named fiduciary who is not a trustee, in which case the trustees are subject to proper directions made in accordance with the terms of the plan and not contrary to ERISA, and (2) when the authority to manage, acquire or dispose of assets of the plan is delegated to one or more investment managers pursuant to section 402(c)(3).

Section 402(c)(3) of ERISA states that a plan may provide that with respect to control or management of plan assets a named fiduciary may appoint an investment manager or managers to manage (including the power to acquire and dispose of) plan assets.

Section 3(38) of ERISA defines "investment manager" as any fiduciary (other than a trustee or named fiduciary) (A) who has the power to manage, acquire, or dispose of any plan asset; (B) who is (i) a registered investment adviser under the Investment Advisers Act of 1940; (ii) a bank; or (iii) an insurance company; and (C) who has acknowledged in writing that he is a fiduciary with respect to the plan.

Section 405(c)(2) of ERISA provides, in part, that if a plan expressly provides for a procedure described in section 405(c)(1), and pursuant to such procedure a person is designated to carry out a fiduciary responsibility of a named fiduciary, then such named fiduciary shall not be liable for an act or omission of such person in carrying out such responsibility except to the extent that (A) the named fiduciary violated section 404(a)(1) -- (i) with respect to such designation, (ii) with respect to the establishment or implementation of the procedure under 405(c)(1), or (iii) in continuing the designation; or (B) the named fiduciary would otherwise be liable under ERISA section 405(a).

Section 404(a)(1)(B) of ERISA requires a fiduciary to discharge his duties to a plan with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

Section 404(a)(1)(D) of ERISA requires a fiduciary to discharge his duties in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of Titles I and IV of ERISA.

II. PROXY VOTING BY PLAN FIDUCIARIES

In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock. For example, it is the Department's position that the decision as to how proxies should be voted with regard to the issues presented by the fact pattern are fiduciary acts of plan asset management: a proposal to change the state of incorporation of a corporation in which a plan owned shares (thereby possibly affecting shareholders' rights to participate in the decision-making process of the corporation which, in turn, affects the value of their investment) and a proposal to rescind "poison pill" arrangements with regard to various corporations in which a plan is invested. Moreover, because voting such proxies involves plan asset management, section 403(a) requires that plan trustees have the exclusive authority and responsibility for voting these proxies, unless one of the two exceptions stated in section 403(a) applies.

To the extent that the documents governing the plan permit a named fiduciary to appoint an investment manager pursuant to sections 402(c)(3) and 403(a)(2) of ERISA to manage, acquire, and dispose of plan assets, there would be an ERISA violation if, during the duration of such delegation, either the trustee or the named fiduciary makes the decision how to vote any proxy appurtenant to shares owned by the plan with respect to which the investment manager has investment authority because under the plan documents neither the trustee nor the named fiduciary has authority to make that decision with regard to those shares. Indeed, under such plan provisions if any person other than the investment manager (or a person under the fiduciary supervision of the investment manager)1/ were to make the proxy voting decision, there would be a section 404(a)(1)(D) violation because that person does not have that fiduciary authority under the plan. Finally, with limited exceptions2/, the named fiduciary, having delegated such responsibility to the investment manager, no longer has the authority to decide how the investment manager votes proxies and would be engaging in a section 404(a)(1)(D) violation in doing so unless, in delegating such management responsibility to the investment manager, it reserves to itself the right to vote proxies.3/

1/ If the investment manager attempted to delegate his responsibility for proxy voting to another, the manager would not be relieved of his fiduciary responsibilities and related liabilities with regard to the voting decisions of that delegatee. (See discussion infra.)

2/ The general fiduciary responsibility provisions of ERISA, including the co-fiduciary liability provisions, remain applicable to the named fiduciary's continuation of the delegation of asset management to the investment manager. Thus, no violation of section 404(a)(1)(D) would occur to the extent that ERISA;s fiduciary responsibility provisions would require the named fiduciary to formally rescind the delegation to preclude the investment manager from engaging in a breach of fiduciary responsibility.

3/ To the extent that a named fiduciary reserves to itself the right to direct the trustee to vote proxies, the investment manager would not have fiduciary responsibility and related liability for the exercise of the vote. Moreover, to the extent the name fiduciary retains the voting rights, it would have full fiduciary responsibility and related liability for the exercise of those rights.

Moreover, ERISA contains no provision which would relieve an investment manager of fiduciary liability for any decision he made at the direction of another person. Under ERISA's construct, only trustees are able to relieve themselves of fiduciary responsibility and related liabilities by accepting directions, if plan documents so provide, and then only if such directions are "proper directions" made in accordance with the terms of the plan and not contrary to ERISA. Furthermore, neither section 3(38) nor 405(c) of ERISA grants an investment manager the powers of a named fiduciary to allocate or designate its investment management function for plan assets to other persons so as to relieve itself of its fiduciary responsibilities and related liabilities. Therefore, to the extent that anyone purports to direct an investment manager as to the voting of proxies, or to the extent that an investment manager purports to delegate to another the responsibility for such voting decisions, the manager would not be relieved of its own responsibilities and related liabilities merely because it either follows the direction of some other person, or has delegated the responsibility to some other person. The manager would continue to have full responsibility (and liability) for the exercise of the proxy voting decision.

Finally, the Department notes that section 404(a)(1)(B) requires the named fiduciary appointing the investment manager to periodically monitor the activities of the investment manager with respect to the management of plan assets. In general, this duty would encompass the monitoring of decisions made and actions taken by investment managers with regard to proxy voting. In this regard, it is the opinion of the Department that section 404(a)(1)(B) requires proper documentation of the activities of the investment manager and of the named fiduciary of the plan in monitoring the activities of the investment manager. Specifically, with respect to proxy voting, this would require the investment manager or other responsible fiduciary to keep accurate records as to the voting of proxies.[4]

4/ Although this letter is concerned with the procedural requirements of ERISA as applied to proxy voting where an investment manager is appointed, the Department wishes to reiterate its longstanding interpretation of the substantive requirements of section 404(a)(1). Section 404(a)(1) requires, among other things, that a fiduciary of a plan act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing (Footnote Continued)

We trust you will find the above information useful in discharging your ERISA responsibilities during the 1988 proxy season and thereafter.

Sincerely,

(Signed) Alan D. Lebowitz

Alan D. Lebowitz
Deputy Assistant Secretary

(Footnote Continued)
benefits to participants and beneficiaries. To act prudently in the voting of proxies (as well as in all other fiduciary matters), a plan fiduciary must consider those factors which would affect the value of the plan's investment. Similarly, the Department has construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives.

News

United States
Department
of Labor

Office of Information Washington, D.C. 20210

PENSION & WELFARE BENEFITS ADMINISTRATION USDL: 88-241

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FOR RELEASE: Immediate
Wednesday, May 11, 1988

PWBA ANNOUNCES ENFORCEMENT PROJECT TO MONITOR INVESTMENT MANAGERS VOTING PROXIES OF EMPLOYEE BENEFIT PLAN

David M. Walker, Assistant Secretary of the Pension and Welfare Benefits Administration of the Department of Labor, today announced the initiation of an enforcement project to monitor how investment managers with control over employee benefit plan assets subject to the Employee Retirement Income Security Act of 1974 (ERISA) are exercising their fiduciary responsibility in voting the stock owned by the plans whose assets they manage.

Specifically, the department through the Pension and Welfare Benefits Administration (PWBA) will determine how selected investment managers are exercising their responsibilities in light of the guidance provided by the department in this area.

Most recently, in February 1988, the department issued a letter in conjunction with an ERISA investigation which provided guidance on how proxy voting should be handled under ERISA. The letter addressed both procedural and substantive requirements, including, among other things, the requirement that such decisions must be made by the persons provided for in the plan document based on what is in the economic interest of the plan and viewing the plan as a separate legal entity established for the purpose of providing retirement income.

The department is currently reviewing data on recent major proxy issues as well as those financial institutions responsible for plan portfolios containing significant stock in those companies. The department plans to contact certain of those investment

- more -

Attachment B

managers in the near future and will seek information on how the responsibility is allocated between the investment manager and other fiduciaries for voting proxies owned by the plan; whether and how the institution voted stock in the selected companies owned by the plans, including information about the internal decisionmaking process used by the manager; and the basis for the decision and appropriate documentation, including whether the investment manager acted on advice of another individual and the basis of such advice. Among other things, the department will examine those instances where an investment manager appears to be basing its decision with respect to the voting of proxies primarily on communications from an individual who has a personal or financial interest in the outcome of the vote, and will pay particular attention to evidence of coercion by such person.

Assistant Secretary Walker stated, "This project is being undertaken to ensure that investment managers meet their responsibility as fiduciaries to properly vote stock owned by employee benefit plans. ERISA requires all investment managers to vote plan proxies solely in the best interest of plan participants and beneficiaries who, through their pension plans, are the beneficial owners of a significant and growing percentage of corporate America."

Recently, PWBA instituted a new enforcement strategy in which 50% of its investigative resources are devoted to two significant issues. One of these issues concerns management of pension fund assets by financial institutions including investment managers, banks, insurance companies, and other financial institutions with discretionary authority over employee benefit pension plan assets. This project is both an outgrowth of the current PWBA enforcement strategy and a response to the important role that employee benefit plans play as major institutional investors and a growing interest in how corporate America is being governed. Employee benefit plans now own 24% of all equities in the United States. In addition, the department estimates that by the year 2000, employee benefit plans will own nearly 50% of all corporate equities in the United States.

The Pension and Welfare Benefits Administration is the agency within the Department of Labor responsible for enforcing the fiduciary and other provisions of Title I of the ERISA. ERISA requires plan fiduciaries, including investment managers, to act solely in the interest of a plan's participants and beneficiaries and with the care, skill and prudence, under the circumstances, that a prudent man acting in a like capacity would use in the conduct of his own affairs.

* * * *

U.S. Department of Labor

Pension and Welfare Benefits Administration
Washington D.C. 20210

Dear Madam or Sir:

The Department of Labor (the Department) has responsibility for the administration and enforcement of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Title I of ERISA establishes standards governing the operation of employee benefit plans and the conduct of fiduciaries with respect to such plans.

Institutions such as yours, serve as fiduciaries for employee benefit plans governed by ERISA and, in that capacity, are responsible for managing those plans' equity portfolios. As part of that responsibility, you have certain duties and obligations imposed by ERISA with respect to the voting of proxies in connection with stock owned by those plans. This letter is being sent as part of an inquiry by the Department to determine whether your institution is properly discharging its responsibilities with respect to the voting of such stock and, in particular, with respect to the proxy issues recently considered by the companies listed in Attachment A. As part of the Department's current inquiry, we hereby request that you provide the information identified below. The time period covered by this request is from January 1, 1988, up to and including the final date of production. However, to the extent documents generated prior to January 1, 1988, (such as correspondence, trustee agreements, investment management agreements or internal guidelines) were in effect or relied on by you after January 1, 1988, such documents should also be produced. Unless original source documents are specified, the requested information can be provided in narrative form. In lieu of the original source documents, copies may be furnished. If you desire a subpoena duces tecum prior to the production of the specified documents, please notify the undersigned immediately and a subpoena will be prompt served on your company.

The requested information consists of:

1. The number of shares of stock in each corporation, listed in Attachment A, contained in the portfolios of employee benefit plans managed and/or held in trust and the number of shares held by each affected plan identified by complete plan name.

Attachment C

2. Identification by name and by position within your trust department of those individuals responsible for decision making with respect to the voting of proxies.

3. Relevant provisions of plan documents and trust agreements pertaining to the voting of stock owned by employee benefit plans that held stock of companies listed in Attachment A (hereafter referred to as "subject employee benefit plans").

4. Each investment management agreement and/or trust agreement between you and the subject employee benefit plans. To the extent your trust department utilizes prototype agreements, this request can be satisfied by the production of such a prototype provided that the Department also be provided with any deviations from that document which concern proxy voting for any of the subject employee benefit plans.

5. Written procedures or guidelines utilized by your institution for deciding how to vote proxies of companies whose stock is owned by the subject employee benefit plans as well as an identification by name and position of all individuals involved in the decision making process.

6. All written decision making memoranda with respect to the voting of proxies of the companies listed in Attachment A and minutes of all committee meetings at which such proxy votes were discussed.

7. In the event any of the subject employee benefit plans provide for pass through voting by participants, the procedures employed by your organization for providing participants with sufficient information to vote their proxies.

8. Any communications including directions or recommendations between representatives of the subject employee benefit plans or their plan sponsors and your institution on the voting of proxies of the companies listed on Attachment A with respect to the 1988 proxy issues, including any written memorialization of such communication or correspondence.

9. How your trust department voted 1988 proxy issues of the companies listed on Attachment A, and all arrangements made for pass through voting of proxies appurtenant to shares held in the accounts of employee benefit plans.

10. Any communications between your institution and representatives of any company listed in Attachment A with respect to 1988 proxy issues, including any written memorialization of such communications or correspondence.

The information requested should be provided within 14 days of receipt of this letter to [name and address] . If you have any questions with respect to this request, or if you desire a subpoena to be served upon your company, please contact [name and telephone number] .

This inquiry is being undertaken in connection with the Department fulfilling its monitoring role in connection with ERISA. It should not be construed as an indication that any violations of law have occurred or as a reflection upon any person involved in this matter. Thank you for what I hope will be your prompt cooperation in this matter.

Enclosed with this letter you will find a news release, dated May 11, 1988, which further describes the PWBA enforcement project.

Sincerely,

Area Director

Enclosures

Mr. MOODY. I am not sure I comprehended the answer to the first part of my question. Are there instrumentalities out there that have no corporate relationship whatsoever with the management, the fact of the company, the pension funds now being managed?

Mr. WALKER. There is an emerging industry now where there are parties trying to engage in just handling a plan's corporate governance obligations. They have no other relationship, and that is starting to emerge now, partially because of the Department's pronouncements as to the importance of proxy voting. Namely, the fact that it can have an economic effect on the value of the stock, it's important to assure corporate accountability and the need to avoid any related conflicting interests.

Mr. MOODY. When you say starting to emerge, really starting—we need a whole new animal to handle this problem. Would that be accurate?

Mr. WALKER. Some have seen it as a new market opportunity and, as you know, where economics are involved, the market tends to follow.

Mr. MOODY. But we are very, very much at the beginning of that, creating that instrument, is that correct?

Mr. WALKER. I would say, yes, we have made a lot of progress, but there is a lot more to be made.

Mr. MOODY. Thank you.

Mr. FORD. Mr. Walker, Mr. Pickle is not here, and there are several other questions that he would like to raise. The chair would like to put those questions to you at this time.

Is there a correlation between a leveraged buyout transaction and subsequent termination of a company's pension plan?

Mr. WALKER. We have not been able to ascertain a direct correlation there. As you know, PBGC Executive Director Kathleen Utgoff testified a couple days ago. They have done some preliminary analysis of that and are following up and doing some more work to try and find out whether there is a significant correlation.

Based on their preliminary work, it is my understanding there is not a significant correlation of heightened degree of risk posed to benefit security because of it. I think it is important to keep in mind that in assessing risk to plan participants and beneficiaries and PBGC, there are several factors that are important. First, there is the funding status of the pension plan, and most defined benefit pension plans, because of, among other things, the equity any other capital market surges since 1982 are very well funded. Second, the nature of the investments in the pension plan, how diversified, how much risk is there; and, third, the financial strength of the plan sponsor. That last point is very important, especially in light of the changes that we had in the Pension Protection Act, because that law strengthened the funding standards and really limited the ability of plan sponsors to terminate pension plans and cast losses on participants and the PBGC.

So we are doing some additional work, but based upon the preliminary work today, which is primarily being conducted by PBGC, it doesn't appear there is a significantly higher correlation in termination risk because of leveraged buyouts today.

Mr. **Ford**. Are companies planning to make acquisitions more likely to terminate their own overfunded pension plans in order to finance the transaction?

Mr. **Walker**. My understanding, based upon the preliminary work that the PBGC has done, since all determinations must be filed with PBGC, is that less than 20 percent of terminations involving an overfunded plan have had a correlation to either a leveraged buyout or hostile takeover attempt. That relates to large plan terminations that have occurred since 1982. But I will be happy to clarify that and revise it for the record, if necessary.

Mr. **Ford**. We would appreciate it, if you don't mind.

One final question: Is there a correlation between the termination of overfunded pension plans and leveraged buyouts? Should Congress consider placing additional restrictions on the ability of companies' use, reversions of gains assets to the surplus assets in their pension plans?

Mr. **Walker**. It would be the same statistic, Mr. Chairman. To date, it appears that less than 20 percent of large terminations involving reversions of overfunded pension plans have related to takeover activity. As a result, overfunded plans do not appear to be a significant cause for or casualty of takeovers or LBO's.

But we will continue to monitor this area, and to the extent that there would be a strong correlation, we would obviously be concerned, as I am sure you would be.

Mr. **Ford**. Thank you very much for your appearance, sir.

The committee would like to call the next panel, Mr. Martin Ginsburg, professor of law at Georgetown University Law Center; Mr. George Yin, professor of law, University of Florida; Mr. David W. LaRue, assistant professor, McIntire School of Commerce, University of Virginia; and Mr. Jack Levin, lecturer in law at the University of Chicago School of Law.

We are delighted to have you before us today. Thank you very much for your appearance before this committee, and the Chair will recognize Dr. Ginsburg.

STATEMENT OF MARTIN D. GINSBURG, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER, WASHINGTON, DC

Mr. **Ginsburg**. Thank you, Mr. Chairman.

Reduction of corporate equity, of the corporate tax base, by distribution of retained earnings or by substitution of debt, as we all know, is currently an extremely popular indoor sport. The techniques vary: LBO's, stock redemptions, extraordinary dividends, so-called unbundled stock recapitalizations on the horizon.

But, as a matter of tax law and tax policy, these are essentially indistinguishable. And setting aside for the moment unbundled stock, they are all old hat. Transactions that have been around for decades are suddenly awarded larger life.

Why? In the case of LBO's, not mainly for tax reasons, I believe, but to the extent the tax law is implicated in any of these things, it is because in 1986, Congress, this committee, inverted the tax rates, the corporate rate is now, and uniquely, 21 percent higher than the individual rate, and you eliminated the preferential tax rate for long-term capital gains. It used to be seen as sensible to incur corporate tax at a low rate and risk a dividend tax later, secure in the knowledge that somehow later would turn out to involve not a fully taxable dividend but a combination of tax-free recovery of stock bases and tax-favored capital gain.

Today it makes no tax sense to incur corporate tax, the highest rate tax, in the first place. The appropriate legislative response, dozens of witnesses by now have pointed out, is enactment of some form of partial integration, coupled with a rate cap on deductible interest payments. But it would lose revenue, and right now I have heard we cannot afford it. Personally, since I believe in corporate shareholder integration, I regret that conclusion, but I do understand it.

However, we ought to recall that partial integration is in its essential and in whatever form it takes simply a lower rate of tax on distributed corporate profits. Thus, all that debt for equity substitution out there, calling for all those payments of deductible interest, is simply do-it-yourself integration.

If we are going to maintain both rate inversion and a facially nonintegrated system in which, in fact, we impose a lower rate of tax on distributed corporate profits through the interest deduction, I sincerely hope you will not at this time attempt by yet more tax legislation to refine the definition of debt or disqualify interest paid on designated sorts of indebtedness, or what have you. History teaches it will not likely prove either effective or sensible, and the unanticipated consequences too likely will prove both unfortunate and substantial. If I may borrow Chairman Greenspan's neat definition of victory from his testimony this morning, you may well do more than a "modest amount of harm."

That is not to say there is nothing worth considering in this Chamber. My written statement is more expansive, but let me suggest a dandy candidate for reform. When a corporation pays currently its interest obligation, well and good. But when the corporation accrues and deducts interest it will not pay for years or decades on original issue discount debt, including payment-in-kind debentures, so-called bunny bonds, and that OID debt is held by a nontaxable person, a pension plan, for example, or a foreign investor, we are permitting a senseless state of affairs. We are affording a lower rate of tax, indeed a zero rate of tax, to undistributed corporate profits. That is not smart.

One tailored response would treat the accruing but unpaid income as unrelated business income taxable to domestic tax-exempt holders and, subject to treaty exceptions, would treat as income subject to 30 percent withholding tax the accruing but unpaid yield on corporate OID indebtedness held by foreign investors.

Now, if you embrace this proposal, I think it fair to predict that the marketing of unbundled stock plans, which do little more than create deep discount OID obligations, will be inhibited, if not entirely foreclosed. As a concerned citizen, I would not account this a misfortune.

Thank you.

Mr. Ford. Thank you very much.

[The statement of Martin D. Ginsburg follows:]

STATEMENT OF MARTIN D. GINSBURG

BEFORE THE

HOUSE WAYS AND MEANS COMMITTEE

On Federal Income Tax Aspects of Corporate Acquisitions

February 2, 1989

Mr. Chairman and members of the Committee:

My name is Martin D. Ginsburg. I am a Professor of Law at Georgetown University Law Center where I teach various subjects in the field of federal taxation. Over the past twenty or so years it has been my privilege to testify before the Ways and Means Committee on a number of occasions, at times at your request, at times on behalf of a bar association group, often simply out of an interest in the subject, but never on behalf of a client. I appear today, at your invitation, as an academic witness, a disinterested witness I like to believe, but certainly not an uninterested one.

The Committee today focuses on corporate combinations, acquisitions, restructurings, and distributions the common effect of which is to reduce the aggregate amount of equity that is in corporate solution in the United States, and the nearly as common effect of which is to increase the level of indebtedness, and thus the debt-equity ratios, of United States corporations. As the Joint Committee staff has rightly pointed out in its excellent January 18 pamphlet (see page 111 et seq.), as a matter of tax law the concern, in the erosion of the corporate equity base, ought to be independent of the form or nature of the commercial transaction. A takeover whether hostile or friendly or somewhere in between, a corporation's repurchase of its own shares, an extraordinary dividend, even the complete liquidation of an enterprise that has sold out to another corporation, in each case the corporate tax base is diminished and a stream of future income will not bear the burden of corporate tax. This is obviously so when the distributing corporation replaces equity -- whether the Target's or its own -- with debt and thereby substitutes deductible interest for nondeductible dividend payments; it is no less so when the transaction is funded with retained earnings the investment of which theretofore generated a stream of corporate income but no longer will.

But there is nothing new in any of this. Large public corporations have for many years redeemed their own shares, often in substantial amounts, employing retained earnings or borrowed funds or both. For cash or debt, corporations took over other corporations before the first Commissioner of Internal Revenue was anointed. Not long ago many argued that the number of taxable corporate acquisitions perhaps, and the sizable premiums paid certainly, at least in important part reflected a great corporate tax loophole known as the General Utilities doctrine. In 1982 and 1984 Congress curtailed, and in 1986 Congress overturned, the General Utilities doctrine. The number of corporate acquisitions and the size of the premiums paid have not declined.[1] I do

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[1] It was similarly argued, not long ago, that the favorable treatment afforded installment sales under section 453 encouraged corporate acquisitions in which selling shareholders received debt obligations (other than "traded" debt). In 1986 Congress

Footnote Continued

believe that an acquisition or distribution that attracts favorable tax consequences is more likely to command a higher price than one that attracts tax disaster, but tax is only one of the factors in the deal equation, in my experience rarely if ever the dominant factor, and in the end buyers pay what they must and sellers get what they can. In short, I do not believe there has ever been a major corporate acquisition of one profitable company by another that was undertaken because a reduction in future corporate taxes might thereby be achieved. I do not believe that three and more years ago, when corporate acquisition tax benefits could be derived from both interest deductions and General Utilities, premiums were mainly attributable to tax advantage. Today, when the interest deduction remains but General Utilities is gone, I am the more convinced that the size of acquisition premiums dominantly reflects perceived values other than future corporate tax savings.

Why, then, do we see such a variety and number of arrangements the common denominator of which is reduction of corporate equity investment through either the distribution of retained earnings or the substitution of corporate indebtedness? Why are old tools, nondividend distributions of one or another sort, in expanded use? Why are corporations today prepared, often in defense against rather than in furtherance of a projected takeover, to debt finance extraordinary dividends of hundreds of millions of dollars and more? Why is Wall Street's latest financial tool "unbundled stock," a substitution of deep discount debt for corporate equity in a recapitalization in which no money changes hands and only tax consequences alter? To what extent is the tax law implicated in the other, more traditional, restructurings?

The tax law is implicated, I believe, because Congress in 1986, by raising the corporate tax rate 21% above the individual rate while eliminating the long-term capital gain rate preference that had made stock sale profits more attractive to individuals than dividend income, substantially curtailed the systemic biases that historically had counterbalanced the tax law's continuing bias in favor of single taxed income. When the corporate tax rate was significantly lower than the individual rate, and a subsequent tax at the shareholder level reliably could be reduced or eliminated though a capital gain sale or redemption or a stepped-up basis at death, it was sensible to incur the corporate tax burden and, often, less sensible to deflect income to a shareholder-creditor, through interest payments on corporate indebtedness, and thereby incur a higher initial tax burden. But too often that is no longer the case. Quite without regard to corporate takeovers or leveraged buyouts or whatever, rational tax planning today inevitably focuses on minimizing or eliminating the corporate tax base, in closely held corporations through the subchapter S regime, in public corporations through some form of practical integration.

Just last week Richard Freling, an extremely able and very experienced tax lawyer, made the point with precision in an

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1/ Footnote Continued From Previous Page

eliminated installment reporting when the stock sold is traded on an established securities market, and in 1988 Congress amended section 453A to render economically unattractive installment reporting of many other deferred payment transactions. Again, no reduction in the number or size of corporate acquisitions has resulted, although it may be that sales that might have been made for installment notes three years ago are today structured as cash transactions.

address delivered to the University of California Securities Regulation Institute in San Diego. In 1977, when the rules and rates were very different, he pointed out, the business and financial communities were overwhelmingly opposed to the adoption of any formal method of corporate-shareholder tax integration. Widely acknowledged, the reason was management's strong disinclination to increase pressures to distribute corporate earnings. Twelve years later, through the adoption of all sorts of leveraged capital structures, the very same folk have embraced with both arms not merely the pressure but the requirement to distribute, in the form of interest on indebtedness, a very large part of corporate operating profits.

Corporate-shareholder integration of other than the complete passthru sort[2] is in its essential a reduced rate of tax on distributed corporate profits. The result can be achieved by explicitly taxing at a lower rate the portion of its profits the corporation elects to distribute; by awarding the corporation a dividends paid deduction for part or all of the funds distributed; by awarding the shareholder an exclusion of part or all of the dividend received; by awarding the shareholder a credit for a specified portion of the corporate tax paid on the income that gave rise to the grossed-up dividend; or by combining more than one of these mechanisms. In a highly leveraged corporate capital structure the interest deduction, when the interest in fact is currently paid, stands surrogate for the dividends paid deduction of a formally adopted integration regime; but because our current integration is practical and not formally acknowledged we impose no effective limit on the size or scope of the integrating interest deduction.

The rational response, as multitudes of witnesses by now have pointed out, is to adopt a formal integration scheme of one sort or another and reformulate the tax law's approach to corporate indebtedness in a manner consonant with the overarching integration scheme. If we are prepared to indulge a lower rate of tax, but not a zero rate of tax, on distributed profits, presumably we would not lightly approve unlimited leverage and an unlimited interest deduction.

At bottom, however, there seems to be a general belief, and I fear an accurate one, that even though a formally integrated system might prove efficient and sensible, it would result in an overall reduction in tax revenues. Few appearing ready to assume that risk, it does not seem likely that Congress will solve the debt-equity substitution problem near term either by adopting a well considered integration scheme or by reversing the tax rate inversion (corporate rate 21% higher than individual rate) that I believe to be a strong contributor to the current state of affairs.

If we are going to maintain a facially nonintegrated system, in which in fact we impose a lower rate of tax on distributed corporate profits by liberally allowing an interest deduction, I sincerely hope neither Congress nor the Treasury will embark on a redefinitional project, whether an expansion of section 279 or another heroic attempt at section 385 regulations or some newly minted misfortune. Disqualifying or penalizing tax legislation, undertaken because a reasoned and encompassing solution was comprehended but found unpalatable, fairly can be relied upon to work neither effectively nor sensibly.

But if we are not now to adopt formal integration, I believe there remains one change, and perhaps two, in present tax law that Congress ought now consider.

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[2] Complete integration of that sort is typified by the partnership (subchapter K) and subchapter S taxing regimes.

Whether formally enshrined or adopted through practical ordering, as earlier noted the core concept of corporate-shareholder integration is a reduced rate of tax on distributed corporate profits. Our present system awards a reduced rate of tax to *undistributed* corporate profits by allowing the corporation a deduction for interest *not* paid, *i.e.* the accrued interest deduction for original issue discount, most significantly for long-term zero coupon bonds, and with respect to payment-in-kind (PIK) or "bunny" bonds.

If the holders of such corporate indebtedness were currently taxable on the accrued but unpaid income, at a 34% or even a 28% tax rate, presumably we would be satisfied or nearly so. But in fact zero coupon bonds and the like in large part are held by persons -- pension funds and foreign investors in particular -- who are not taxed on currently accruing discount or other unpaid interest income. In practice, therefore, we have promoted a system of "integration" that comprehends a zero rate of tax on a significant part of *undistributed* corporate earnings measured before returns to capital. I do not think this makes any sense.

I recognize that the tax system harbors competing values and policies. Congress intends to exempt certain classes of income earned by pension funds and foreign investors, particularly treaty country foreign investors. The mandatory accrual taxing regime for OID instruments was recently and intricately redesigned. Any suggestion that we scrap the entire construct and replace it with mandatory cash method reporting likely would be received with very modified rapture, and I do not make it. Instead, rather than propose that the debtor corporation be disallowed a current deduction for yields accrued but unpaid, I suggest Congress consider a narrowly tailored surrogate taxing regime: treat the accruing but unpaid income as unrelated business income to pension trusts and other domestic tax exempt holders; subject to treaty exceptions hereafter negotiated, treat as income subject to 30% withholding tax the accruing but unpaid yield on corporate indebtedness held by foreign investors.[3]

Congress might consider, although with appropriately nervous care, a far out interest rate cap (*e.g.*, interest on corporate indebtedness is not deductible to the extent the rate exceeds the Treasury Bill rate by more than 10%). Personally, I hope Congress will not do so, at least at this time, in the absence of any good reason to believe extraordinary interest rates of this sort pose an important or even a growing danger to the Republic's revenues. More fruitfully, I think, if minded to strike but one more blow Congress might aim it at the amazing pile of favorable Code provisions that govern the tax treatment of ESOPs and their employer corporations, lenders, reinvesting sellers, dead stockholders, and more. If none of these rules was in the Code, and all were presented to this Committee one morning for enactment as a package, I sincerely hope the proposal would not attract a single vote. Second only to the tax treatment of OID instruments in the hands of nontaxable persons, the overbearing aggregate of ESOP rules seems to me a fine candidate for reform.

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[3] Pension plans and foreign investors would of course be unlikely to acquire OID instruments after such a change in tax law. As a practical matter, that alteration in investment practice would at the least inhibit, and perhaps foreclose, implementation of unbundled stock plans (which create deep discount OID obligations). I would not account this an undesirable consequence.

Mr. **Ford**. Dr. Yin.

Mr. **Yin**. Thank you.

I understand Mr. Levin's testimony follows up to some extent on Professor Ginsburg's testimony, and with the chairman's permission, I would be happy to let him go first.

Mr. **Ford**. That would be fine with the Chair.

STATEMENT OF JACK S. LEVIN, LECTURER, UNIVERSITY OF CHICAGO LAW SCHOOL

Mr. **Jack Levin**. I am a lecturer at the University of Chicago Law School and a partner in the law firm of Kirkland & Ellis. Professor Ginsburg and I have coauthored a three-volume book published last month on mergers, acquisitions, and leveraged buyouts. I do not testify here on behalf of any client, but rather to express my personal views in what I conceive to be the best interest of our Nation.

While I am not an economist, I have observed at short range hundreds of transactions of the type being reviewed by this committee and firmly believe the great majority have benefited our economy. Inevitably, however, there are excesses.

When a pendulum swings in a good direction, it often swings a bit too far. But experience tells us that we cannot effectively legislate a tax only on bad buyouts without also impeding all the beneficial ones. I, therefore, urge legislative moderation at this time. Do not enact drastic legislation which will break or severely bend the economic pendulum in midswing.

Before dealing specifically with the moderate steps this committee might take at this time, I would like to refute three oft-repeated misconceptions. The first misconception is that leveraged buyouts are creatures of the tax law. Buyouts occur because a buyer believes the business is undervalued by the market. Many factors play a large role in this process: interest rates, the business climate, competition. Taxes play a very minor role.

The second misconception is that leveraged buyouts significantly reduce tax collections. When an LBO takes place, the old shareholders of the company recognize gain. There are four reasons this front-end capital gain is particularly sweet for the Treasury.

First, all the company's stock is sold now rather than in dribs and drabs over the next 20 years. Hence, the present value of the tax is vastly enhanced.

Second, capital gains are now taxed at the same rates as ordinary income. There is no longer a low preferential rate for capital gains.

Third, all those shareholders who expected to hold their stock until death eradicated the capital gains tax must pay tax at the time of the LBO.

Fourth, the premium price over market substantially increases the amount of capital gains. Moreover, it is simply not accurate to say that the interest expense paid by the company on its corporate-level indebtedness avoids corporate-level tax altogether. Much of the LBO interest is paid to banks, insurance companies, and other corporate lenders subject to corporate taxation. To this extent, the income simply hops over from the LBO company to the corporate lender.

The third misconception is that the problem can now be cured by treating debt and equity the same and allowing a deduction or a credit for corporate dividends. While such a change in the tax law would be excellent, we clearly cannot now afford the billions of dollars of revenue loss that integration would entail.

There are thus, in my opinion, two sound courses of action for this committee. First, listen to all the pros and cons regarding this extremely complicated set of economic issues, instruct Treasury to make a comprehensive study, but do not enact any piecemeal tax legislation at this time, because more harm than good can result from bending the complex economic pendulum in midswing.

One example of almost bending the pendulum is the economic disruption of October 1987. While there is no clear evidence that the House-proposed bill caused or contributed to the October 19 disruption, the dramatic juxtaposition of events counsels for even more caution in the future.

Moreover, the drastic step of disallowing a deduction under U.S. tax law for acquisition interest would put American buyers at a severe disadvantage to many foreign buyers. While an American buyer would be prevented from deducting acquisition interest, a foreign buyer's home jurisdiction may well allow it to deduct on its foreign tax return all of its acquisition interest. Such a solution may, therefore, reduce buyouts of American companies by American buyers but exacerbate buyouts of American companies by foreign buyers.

A second sound course of action for this committee, if it believes that a change in the tax laws is necessary now, would be to adopt one or several fine-tuning tax changes which may redress the pendulum a bit, but not bend it beyond repair. I discuss four such fine-tuning changes in my prepared testimony previously submitted.

In brief, one deals with debt instruments which under the current law, as mentioned by Professor Ginsburg, allow the corporate obligor to deduct interest not paid, such as zero coupon debentures and payment-in-kind or PIK debentures. Now, in a theoretical world, it does not matter that the corporate obligor deducts the interest not paid each year on a PIK debenture because the tax law requires the holder to pay tax on the interest income he does not receive.

However, in a real world virtually all zeroes and PIK's are held by tax-exempt or foreign entities. Therefore, it may be appropriate to impose an additional tax burden on this type of instrument, either disallowing the company's interest deduction until it actually pays the interest in cash or by taxing even a tax-exempt or foreign holder on interest accrued on such an instrument.

A second fine-tuning legislative proposal would impose an additional tax burden on interest in excess of a maximum rate, for example, eight points over the rate payable by Treasury on debt with a comparable maturity. Such additional tax burden might be imposed on the corporate obligor in the form of an interest deduction disallowance or on the holder, perhaps by taxing holders otherwise tax exempt.

A third fine-tuning proposal would deal with the current crazy quilt of tax benefits which encourage ESOP's to borrow money to buy stock. If you reexamine the tax benefits of leverage generally, it would be worthwhile also to reexamine these ESOP tax incentives which encourage a form of greater leverage.

The fourth and last, and somewhat more drastic fine-tuning proposal, would focus on the fact that some investors in highly leveraged securities, namely tax-exempt entities and foreigners, are exempt from U.S. tax on certain types of passive income. Hence, it may be appropriate to tax an investor on its income from highly leveraged investments at full U.S. rates regardless of its special status or, alternatively, to tax them unless the instrument is not held for at least a prescribed period with the tax rate declining as the holding period increases.

These four legislative proposals have, in my view, one thing in common. They are fine-tuning adjustments to cure possible tax abuses and would redress the pendulum a bit, but not bend it beyond repair.

Finally, I believe it crucially important that any action by this committee must be viewed in conjunction with actions by the eight other congressional committees and the many Federal agencies reviewing LBO's so that the cumulative effect of these actions does not overwhelm the free market and drastically affect our economy.

Thank you very much.

[The statement of Jack S. Levin follows:]

Testimony Before The House Committee on Ways and Means

By

Jack S. Levin
Lecturer, University of Chicago Law School

Regarding

The Tax Policy Aspects of Mergers & Acquisitions

February 2, 1989

Introduction

I am a lecturer-in-law at the University of Chicago Law School, where I teach a course in structuring entrepreneurial transactions. I am also a partner with the law firm of Kirkland & Ellis where I specialize in mergers, acquisitions, buyouts, and venture capital transactions. Along with Professor Ginsburg, I am co-author of a three volume book published last month on Mergers, Acquisitions, and Leveraged Buyouts. I do not testify here on behalf of any clients or the University of Chicago Law School, but rather I am here to express my personal views in what I conceive to be the best interest of our nation.

I believe that most mergers, acquisitions, and buyouts in recent years have, on the whole, been beneficial for our country. While I am not an economist, I have observed at short range hundreds of transactions in recent years. Many of these transactions have moved inefficient companies into the hands of more efficient managers, reduced unnecessary corporate overhead, caused acquired business to be operated in a more entrepreneurial fashion, created jobs, allowed selling shareholders to realize enhanced values, and allowed buying shareholders to build values.

These transactions have given public shareholders, pension plans, mutual funds, and the like the opportunity to share in a control premium rather than requiring them merely to sell their shares in small lots at the discounted minority price.

This does not mean that every merger, acquisition, and buyout has been good for our economy and has been soundly structured. Inevitably there are excesses; when a pendulum swings in a good direction, it often swings a bit too far. If we knew the magic formula, this Committee could adopt legislation imposing a stiff tax on bad buyouts which are unsoundly structured, but draft the legislation so that it would not impede soundly structured buyouts which are beneficial for our economy. However, experience tells us that we can not effectively legislate such a fine distinction.

I therefore urge legislative moderation at this time. Do not enact drastic legislation which will break or severely bend the pendulum. Our economy would feel the adverse effects of such legislation for a decade to come. The market is self-correcting. It will deal effectively with excesses. Investors will quickly learn not to invest in unsound buyouts.

Three misconceptions

Before dealing specifically with the moderate steps this Committee might take at this time, I would like to deal with three oft-repeated misconceptions.

First misconception: LBOs are creatures of the tax law

The first misconception is that leveraged buyouts are creatures of the tax law, i.e., they are largely motivated by the desire to obtain interest deductions. That is, in my experience, simply not true. Buyouts occur because a business is undervalued by the market and the buyer believes it can improve the business so that it will be more valuable than the purchase price. Many factors play a much larger role in this process: interest rates, the business climate, foreign and domestic competition, the management team's skills, and expectations as to the ability to expand the company's sales. Taxes play a very minor role in this process.

Second misconception: LBOs reduce tax collections

The second misconception is that leveraged buyouts reduce tax collections. Although LBOs substitute debt for equity, I do not believe that they reduce the government's tax collections. When an LBO takes place, the old shareholders receive a very large premium over the prior market price of their stock. Their gain on the sale of their shares is immediately taxable. There are four reasons this front-end capital gain tax is particularly sweet for the Treasury:

1. The LBO accelerates the timing of a sale. All of the company's shareholders must sell now rather than selling their stock in dribs and drabs over the next twenty years. Hence the present value of the tax is vastly enhanced.

2. Capital gains are now taxed at the same rates as ordinary income. There is no longer a low preferential rate for capital gains.

3. All those shareholders who expected to hold their stock until death eradicated the capital gain tax must pay tax at the time of the LBO.

4. The premium price over market swells the amount of capital gain.

Thus the present value of the front-end capital gain tax very likely more than offsets any corporate tax lost over the life of the debt, taking account of the obvious fact that the company repays the debt as quickly as possible.

Moreover, it is simply not accurate to say that the interest expense paid by the company avoids corporate-level tax. Much of the LBO interest is paid to banks, insurance companies, and other corporate lenders so it is subject to corporate taxation and ultimately shareholder-level taxation -- the income simply hops over from the LBO company to the corporate lender.

As described in the Joint Committee Staff's excellent pamphlet of 1/18/89, a portion (less than half) of the lenders are foreign or tax-exempt entities. As I will discuss in a moment, perhaps one of the fine-tuning provisions you should adopt is to tax foreign and tax-exempt entities on all or part of the interest income arising out of transactions of this type.

**Third misconception:
Debt and equity should
now be treated the same**

The third misconception is that the problem can be cured by treating debt and equity the same and allowing a deduction (or credit) for corporate dividends. While such a change in the tax law would be excellent, we clearly can not now afford the billions of dollars of revenue loss that integration would inevitably entail. Moreover, to adopt only prospective integration (in order to reduce the revenue loss) would bring more complexity: If you enacted a deduction (or credit) for dividends only on new equity, we would need complex anti-churning rules to prevent every corporation in America from issuing new equity securities and using the proceeds to redeem its old equity securities. This would entail tracing rules and rules regarding extraordinary dividends and other complex financial transactions. Hence I do not believe that a practical solution lies in granting a deduction (or credit) for dividends paid.

**First sound course of action:
Begin a comprehensive study**

There are in my opinion two sound courses for this Committee: First, listen to all the pros and cons regarding this extremely complicated set of economic issues, instruct Treasury to make a comprehensive study, but do not enact any piecemeal tax legislation at this time. The issues we are dealing with are too complex for a quick fix; more harm than good can result from bending the complex economic pendulum in mid-swing.

October 1987 experience. One example of bending the pendulum is the proposed 1987 House Bill, introduced in early October 1987, which would have disallowed acquisition interest in excess of $5 million per year. Within a few days after this proposal, on October 19, 1987, the patient nearly expired. While there is no clear evidence that the House proposal caused or contributed to the crash, the dramatic juxtaposition of the events counsels for even more caution in the future.

Competitive disadvantages for U.S. buyers. We must also be vigilant that the solution to one illness does not exacerbate another even more serious illness. Disallowing a deduction under U.S. tax law for acquisition interest would put American buyers at a severe disadvantage to many foreign buyers. It would prevent an American buyer from deducting acquisition interest. But a foreign buyer's home jurisdiction may well allow it to deduct on its foreign tax return all of its acquisition interest. Such a solution may therefore reduce buyouts of American companies by American buyers but exacerbate buyouts of American companies by foreign buyers.

**Second sound course of action:
Fine-tuning changes in the tax law**

A second sound course for this Committee, if it believes that a change in the tax law is necessary now, would be to avoid a drastic legislative change which may impede legitimate transactions for years to come, and instead adopt one or several fine-tuning changes which may redress the pendulum a bit but not bend it beyond repair. I will suggest several such fine-tuning changes which would not disrupt our economy but would deal specifically with several possibly tax-abusive situations.

**First fine-tuning proposal:
Zero coupon and PIK debentures**

First, there are two categories of debt instruments that do not pay interest in cash, but under current tax law the corporate obligor is nevertheless entitled to a tax deduction each year for the interest not paid. One type is called "zeros" or zero-coupon debentures. This means that the corporate obligor pays no interest; rather, the interest accrues and is paid when the bond matures, perhaps after ten years. A second type is called "PIK" or payment-in-kind debentures. This means that each year the corporate obligor pays the interest by issuing another PIK debenture, so that at maturity, perhaps after ten years, the obligor pays both the original debenture plus all the little PIK progeny. In a theoretical world it does not matter that the corporate obligor deducts the interest not paid each year on a zero or a PIK debenture, because the tax law requires the holder to pay tax on the interest income he does not receive. However, in a real world virtually all zeros and PIKs are held by tax-exempt or foreign entities (e.g., pension plans, IRAs, university endowment funds).

So if I were to single out a type of debt that is fueling buyouts in a possibly tax-abusive manner, it would probably be those that deliver a tax deduction to the corporate obligor without requiring it to pay any interest in cash. Therefore, I believe it may be appropriate to impose an additional tax burden on this type of instrument. The proper tax burden could be either (a) to disallow the company's interest deduction until it actually pays the interest in cash or (b) to tax even a tax-exempt or foreign holder on interest accrued on such an instrument.

Second fine-tuning proposal:
Interest in excess of a maximum rate

A second fine-tuning legislative proposal would focus on the fact that some buyouts use debentures carrying yields markedly above normal debt rates. It may be appropriate to impose an additional tax burden on the interest in excess of a maximum rate, for example, eight points over the rate payable by the Treasury on debt with a comparable maturity. The additional tax burden might be imposed on the corporate obligor in the form of a deduction disallowance or on the holder, perhaps by taxing holders otherwise tax-exempt. Because of the difficult definitional issues, it would not in my view be proper to taint an entire debt instrument merely because the yield may be slightly higher than the established rate -- it would be fairer to taint only the interest in excess of the established rate.

Third fine-tuning proposal:
Reduce the ESOP incentives

A third fine-tuning proposal would be to withdraw some of the tax incentives for ESOPs. ESOPs have frequently sponsored leveraged buyouts of their employer companies and in light of recent judicial decisions, ESOPs may now become a defensive takeover device. Current tax law grants a crazy-quilt of tax benefits to ESOPs:

1. Rollover exemption from capital gain recognition to a shareholder selling stock to certain types of ESOPs.

2. Estate tax reduction to an estate selling stock to certain types of ESOPs.

3. Reduced tax rate on the interest income received by a lender to an ESOP.

4. Tax deduction for the sponsoring company when it repays both the principal and interest on an ESOP's borrowing.

5. Tax deduction for a company paying dividends on its stock held by an ESOP.

If you reexamine the tax benefits of leverage, it would be worthwhile also to reexamine these ESOP tax incentives which encourage greater leverage.

Fourth fine-tuning proposal: Tax foreign and tax-exempt entities on income from leveraged investments

A fourth, and somewhat more drastic, fine-tuning proposal would focus on the fact that some investors in highly leveraged securities, namely tax-exempt entities and foreigners, are exempt from U.S. tax on certain types of passive income (or under certain circumstances pay tax at a drastically reduced rate). It may be appropriate to tax such an investor on its interest income, dividend income, and capital gain income from highly leveraged investments at full U.S. rates regardless of its special status. (Any change in the tax treatment of a foreign person suggested in this testimony would, of course, have to be consistent with our treaty obligations. In addition, if special rules are applied to "highly leveraged investments" or a similar category, the definitional issues would be formidable.)

Alternatively, a somewhat less drastic approach would be to focus on the difference between short-term and long-term holders of highly leveraged investments and to tax persons currently exempt from tax, i.e., foreign and tax-exempt entities, on gains from such stock and debt instruments not held for at least a prescribed period -- with the tax rate declining as the holding period increases.

These four legislative proposals have, in my view, one thing in common: They are fine-tuning adjustments to cure possible tax abuses and would redress the pendulum a bit, but not bend it beyond repair, i.e., they are not so drastic as to threaten the free market system.

Cumulative effect of tax and non-tax legislation and regulations

Finally, I believe it crucially important that any action by this Committee must be viewed in conjunction with action by the eight other Congressional Committees and the many federal agencies reviewing LBOs, so that the cumulative effect does not overwhelm the free market and drastically affect our economy. Among the non-tax points which may now be addressed, and would in my view, fit within the fine-tuning framework, are:

1. Make clear that trustees (of a pension plan, a university endowment fund, etc.) are not required by fiduciary duty to sell whenever a buyout proposal is made at a premium over market, but rather that trustees are entitled to take into account their good faith expectations as to future share performance of the company if the buyout is rejected.

2. Require institutional investors (such as banks, pension plans, university endowment funds) to disclose separately in their financial statements all risky investments, whether oil and gas, real estate in depressed areas, or LBO investments, so that appropriate regulators and the people to whom the institution's management are responsible can judge management's performance.

3. Where an institution is regulated (e.g., a bank), make sure the appropriate regulators are empowered and encouraged to require additional reserves on new capital whenever the institution's overall financial condition (including the risky investments) warrant.

Mr. Ford. Mr. Yin.

STATEMENT OF GEORGE K. YIN, PROFESSOR, UNIVERSITY OF FLORIDA COLLEGE OF LAW

Mr. Yin. Thank you, Mr. Chairman.

I am delighted to be here today to respond to your committee's request for testimony on this important subject.

I appear today solely on my own and not on behalf of any group or client interest.

In view of the time limitations, let me just briefly summarize my comments. First, I believe that the tax system does subsidize many LBO's and corporate restructuring transactions and the subsidy derives from the erosion of the corporate income tax base that results from these transactions.

Now, if the committee's policy goal is to eliminate that tax subsidy and preserve the corporate tax base, what should it do? It seems to me one thing not to do would be simply to enact or adopt a flat cutback of the corporate interest deduction, whether based on debt-equity ratios, instrument yield or some percentage disallowance formula.

To illustrate my concern in this area, consider a situation where one of your small corporate constituents is undergoing a business expansion, and in order to finance that expansion, it has to incur debt. It seems to me the interest on that debt ought to be deductible by that corporation regardless of the yield that is offered on the instrument, the corporation's debt-equity ratio or any similar factor.

And the reason for this is that although the interest deduction will in a sense shelter future taxable income of the corporation, so long as the proceeds of the debt are retained by the corporation and produce taxable income, then there is no erosion of the corporate income tax base.

Now, to be sure, there are, of course, potential problems with this analysis: for example, where the proceeds are used to produce economic income but not taxable income, or because the tax system does adequately take into account the effects of inflation on the debt. But it seems to me those types of problems—and they are important ones, and they are ones that perhaps the committee at some point ought to look at—are not ones that are unique to corporate debt.

And, therefore, my assumption is that they are not the primary focus of today's hearings.

What should the committee do if the policy is to eliminate the tax subsidy and preserve the corporate tax base? Conceptually, to find the answer, I find it useful to go back to the roots of our corporate tax system.

We have a two-tiered corporate tax system. Income is taxed first at the corporate level when it is realized, and then it is taxed again on distribution out of the corporation.

I believe that the subsidy involved in many of these transactions arises from deficiencies in collecting either or both of these two tiers of tax. For example, as to the shareholder-level tier of tax, the committee should ask itself whether these restructurings result in a out of the corporation distribution without the proper payment of the distributions tax.

Important studies have suggested that is exactly the case. If so, then there are remedies that are available and appropriate to collect that tax.

Similarly, as to the corporate-level tier of tax, we, for the most part, no longer have the problem of an exemption of tax on corporate-level gains because of the changes that this committee has adopted over the last 5 to 7 years repealing the so-called *General Utilities* doctrine.

But there is still the important question of timing. When do we collect the unrealized gains in the corporate sector?

In that regard the committee must ask itself whether the leveraging of appreciated assets should result to some extent in the realization of those corporate level gains. That seems, in part, to be the theory behind the committee's proposals in 1987. I think that it is an appropriate area to continue to examine.

Let me conclude with the following observation. You all have heard the much overused phrase, "If it ain't broke, don't fix it."

In the context of today's hearing, proponents of LBO's sometimes argue that it ain't broke. Their argument is that there is no tax subsidy involved because, in fact, there are substantial other taxes being paid in excess of any tax benefits produced.

What are those other taxes being paid? Well there are principally two. One, there is a substantial shareholder-level tax paid by the selling shareholders in these transactions.

The other tax that supposedly is present is a substantial corporate-level tax arising from corporate asset sales that are often an integral part of these restructurings. Of course, we can only speculate as to how sound any of these positions are.

The proposal that I am advocating here essentially takes some of the speculation out of that question. If, in fact, LBO's are not tax subsidized and substantial taxes are being paid, then the proposal that is advocated here will have little or no effect on those transactions.

For the proposal is simply designed to collect a tax or taxes that are, in fact, already being collected. The committee can then say that "on further reflection we have discovered that it wasn't broken, and therefore, we didn't fix it."

On the other hand, if it turns out that LBO's are tax subsidized and that, in fact, substantial other taxes are not being paid, then, of course, the proposal that I am suggesting to you today will have a significant effect on those transactions.

But then it should. Then it would be appropriate because the committee will have determined the transactions are tax subsidized. The committee can then say: "we discovered it was broke, and therefore we did it."

Thank you very much.

[The statement of Mr. Yin follows:]

STATEMENT OF GEORGE K. YIN, PROFESSOR, UNIVERSITY OF FLORIDA COLLEGE OF LAW

My name is George K. Yin. I am a professor at the University of Florida College of Law where I specialize in Federal income taxation and particularly, the income taxation of corporations and shareholders. I have spent a number of years, first in private practice, then as a staff member to the Senate Finance Committee, and now as a law professor, studying some of the issues raised by today's hearing. I am pleased to respond to your Committee's request for testimony on this important subject. I appear today solely on my own, and not on behalf of any group or client interest.

Current corporate restructurings are tax subsidized

In announcing these hearings, the Chairman expressed the Committee's particular interest in ascertaining the extent to which the tax system encourages leveraged buyout transactions and other forms of corporate mergers and acquisitions. In my view, the current income tax system is not neutral with respect to such forms of corporate restructurings, but rather subsidizes them through the dissipation of the corporate income tax base that results from the transactions. I don't know whether this tax subsidy has, in fact, influenced corporate behavior, but there is clearly the potential for such influence.

The wrong way to address the problem

If the Committee's policy objective is to eliminate the tax subsidy in these transactions and thereby preserve the corporate income tax base (as is suggested by recent legislative changes adopted by this Committee and enacted by Congress), then adoption of proposals that simply cut back the corporate interest deduction based upon instrument yields, debt-equity ratios, flat percentage disallowance formulae, or similar tests, would not be advisable steps. None of these blanket disallowance proposals is precisely targeted enough to accomplish the desired policy goal.

A simple example should illustrate my concern. Assume that one of your small corporate constituents is in the process of a business expansion. In order to finance the expansion, the corporation must incur additional debt. It seems clear to me that such a corporate constituent should be entitled to deduct the interest on that debt regardless of the corporation's debt-equity ratio, the yield offered on the debt instrument, or any similar factor. The reason for this is that although the new debt may generate future interest deductions that will shelter to some degree future corporate income, the corporation also retains the proceeds of that debt, which presumably will generate additional taxable income for the corporation.[1] Indeed, one would assume that ordinarily, the income generated by the proceeds will exceed the deductions created by the debt. Thus, there is no reduction in the corporate income tax base. In that sense, interest paid or accrued on a business loan might be viewed as nothing more than a rental payment for the use of the money borrowed, and just as business rents are ordinarily deductible, so should interest expense ordinarily be deductible.

To be sure, there are important other reasons that might cause one to question whether the interest deduction produces an accurate measurement of net income. One such reason involves the issue of whether the tax treatment of debt properly accounts for the existence of inflation.[2] But those concerns involve debt generally, and not just corporate debt, so that I assume they are not the primary focus of today's hearing.

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[1] The income tax code is filled with provisions which address the potential problem of "tax arbitrage", where the proceeds of debt may generate economic, but not taxable, income. See, e.g., I.R.C., § 265(a)(2). Because these issues do not relate solely to corporate interest deductions, I assume that they are not the present focus of the Committee's concern.

A better way to eliminate the subsidy

If the concern, then, is the erosion of the corporate tax base, some consideration must be given to the use of the debt proceeds. Thus, a proposal that limits the disallowance of interest deductions only to the extent the underlying debt is used to replace existing corporate equity is properly tailored to meet the policy objectives. But some have criticized this proposal because it creates the administrative difficulty of having to "trace" the debt proceeds. Moreover, it does not provide a complete solution because the corporate tax base may be dissipated in certain types of corporate restructurings even in the absence of any corporate debt. For example, a share buyback transaction undertaken by a corporation without any debt whatsoever may, nevertheless, be partially tax subsidized under current law.

An even better solution

There is, in fact, an even better method of addressing the problem. Conceptually, this alternative proposal is based on the notion that the Congress takes seriously the existence of our two-tier corporate income tax system. Under our two-tier system, income is taxed first to the corporation as it is realized, and then after-tax proceeds are taxed once again upon distribution out of the corporation to its shareholders.

I believe that the tax subsidy under current law in many corporate restructuring transactions results from potential deficiencies in collecting each of those two tiers of tax and that the proper remedy, therefore, is to correct these deficiencies. Thus, as to the "shareholder-level" tier of taxation, the Committee should consider whether the corporate restructuring results in a distribution of funds out of the corporation without proper payment of the tax to the distributee. Important studies have suggested that this may exactly be the case.[3] A possible remedy would then involve insuring the collection of the proper tax at the time of the distribution of funds out of corporate solution, perhaps through imposition of a distributions tax on the corporation in lieu of the normal tax collected from the shareholder.

Similarly, the Committee should determine whether the proper "corporate-level" tax is being paid with respect to these transactions. Here, the matter is simplified somewhat by the positive changes adopted by the Committee and enacted by Congress over the last seven years that have effected the repeal of the so-called General Utilities doctrine. There is now, for the most part, no longer an issue as to whether a corporate restructuring may result in an exemption of corporate-level gains from tax, but there is still the important question of timing. For example, is the incurrence of debt secured largely by unrealized corporate-level gains the occasion for ending the tax deferral permitted by the realization doctrine?[4] While, undoubtedly, an affirmative answer would be controversial, perhaps it is time for the Committee to give this question close scrutiny.[5] The Committee might well decide that the leveraging should trigger the realization of the corporate gains, at least to the extent the debt exceeds corporate asset basis. In that connection, the 1987 proposals of this Committee on these issues[6], which I view in a generally positive light, appear to be based in part upon these concerns.

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[2] See, e.g., "Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President" (November, 1984), Vol. II, pp. 193-200.

[3] "Reporter's Study of the Taxation of Corporate Distributions" in American Law Institute, Federal Income Tax Project: Subchapter C 327 (1982). Further work has since been done on this study. See also Bryan, "Leveraged Buyouts and Tax Policy," 65 No. Car. L. Rev. 1039 (1987).

If the Committee focuses its attention on whether each tier of tax is properly being collected in these corporate restructuring transactions, it may well discover that the presence of corporate debt is implicated. For example, a leveraged recapitalization or buyout may involve the incurrence of corporate debt, the proceeds of which are then used to replace existing equity. But I reiterate my view that corporate debt alone is not the problem, and that therefore, any proposal that deals strictly with limiting the corporate interest deduction (without any attention paid as to how the proceeds are used) would be ill-advised. It is only where the corporate debt is combined with "something else" (for example, a distribution out of the corporation to retire existing corporate equity, or the presence of unrealized corporate-level gains) that a tax subsidy may be created. Thus, if the Committee determines to eliminate the subsidy, it is appropriate first to identify the "something else" and then to fashion a response with that "something else" in mind.

There is one other advantage to this proposed solution. Proponents of leveraged buyouts and other corporate restructurings have sometimes argued that such transactions actually increase, rather than decrease, overall tax revenues. In other words, there is no tax subsidy for the transactions. The two principal reasons for this are that such transactions result in the collection of:

-- a sizable "shareholder-level" tax, in the form of a capital gains tax on selling shareholders; and
-- a sizable "corporate-level" tax, resulting from corporate asset sales that are part of the restructuring.[7]

But for the most part, there has been only speculation as to whether these positions are sound.

The remedy advanced here essentially eliminates the speculation on this issue. It "calls the bluff," if you will. If, in fact, leveraged buyouts and similar transactions are not tax subsidized but rather result in sizable shareholder- and corporate-level taxes being paid, then this proposal will have little or no effect on the transactions, for the proposal is merely designed to collect those taxes which, apparently, are already being paid. Thus, the transactions would move forward without interference, with Congress simply being assured that the Treasury is sharing in the ostensible wealth created by the restructurings.

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[4] Cf. Woodsam Associates, Inc. v. Commissioner, 198 F.2d 357 (2d Cir. 1952).

[5] Recent tax law changes such as former § 453C and current § 453A(d) suggest a willingness on the part of Congress at least to give this question a fresh look.

[6] H. R. Rept. No. 100-391, 100th Cong., 1st Sess. 1085 (1987).

[7] See, e.g., Newport, "Why the IRS Might Love Those LBO's," Fortune Magazine 145 (December 5, 1988).

If, on the other hand, sizable shareholder- and corporate-level taxes are not being paid as a result of the transactions, then, of course, the proposal will have a considerable impact. But in that case, it should, for the transactions will have been shown to be tax subsidized, and the proposal will simply effect the Congressional goal of eliminating the subsidy.

Dividend relief proposals

I have two final comments which both relate to proposals to integrate, or partially integrate, the corporate income tax system. Certain witnesses have testified that adoption of some form of dividend relief, whether by means of a dividends paid deduction or a shareholder credit or "imputation" system, would be one means of providing greater neutrality in the current tax system.

Before adopting any partial integration proposal, I think the Committee should carefully consider whether dividend relief should be limited only to "new equity" contributions after the effective date of the proposal. Some have suggested that current share prices already reflect the anticipated tax burden of a dividend or other corporate distribution upon the withdrawal of existing capital from corporate solution.[8] To the extent these views are correct, any dividend relief proposal applicable to existing corporate equity may simply produce a windfall benefit to existing shareholders.

More importantly, in weighing the advisability of adopting a partial integration approach, the Committee should not simply compare the benefits of an integrated corporate tax system with an unintegrated one. That is a false comparison, for integration proposals would result in an overall reduction in the tax revenues that are currently being collected. It is perhaps not surprising, then, that integrated regimes tend to compare favorably with unintegrated ones. It is like saying that if taxes were cut, the economy would operate more efficiently. That would be true, but it does not provide any meaningful guidance to the Committee as to which course of action to follow.[9]

Thus, the relevant inquiry is to contrast our current unintegrated regime with an integrated one (or partially integrated one) plus whatever additional provisions that must be added in order to make up for the revenue shortfall. From the standpoint of equity, simplicity, and efficiency, which of those two options is preferable? Obviously, without knowing what the additional provisions are, I cannot make that comparison, but I believe it is the one this Committee should make before adoption of any integration proposals.

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[8] See, e.g., Bradford, "The Incidence and Allocation Effects of a Tax on Corporate Distributions," 15 J. Publ. Econ. 1, 3, 21 (1981); Auerbach, "Taxation, Corporate Financial Policy and the Cost of Capital," 21 J. of Econ. Lit. 905, 923-26, 934 (1983).

[9] David Brockway, former chief of staff of the Joint Committee on Taxation, made exactly the same point at a tax conference about 1-1/2 years ago, when he stated that if taxes were eliminated completely, many of the biases and complexities of current law would disappear. Corporate Tax Reform 83 (G. Yin and G. Mundstock eds. 1988). Although he was being facetious, he was absolutely right, and thereby illustrated the same false comparison.

Mr. FORD. Mr. LaRue.

STATEMENT OF DAVID W. LaRUE, PH.D., ASSISTANT PROFESSOR, McINTIRE SCHOOL OF COMMERCE, UNIVERSITY OF VIRGINIA

Mr. LARUE. Mr. Chairman, my name is David LaRue.

I am an assistant professor at the McIntire School of Commerce at the University of Virginia. I am not appearing on behalf of any special interest or group. I intend to keep my oral comments general, and brief, and to leave detailed illustrations and observations to my lengthy prepared statement which I ask be included in the record.

Once the decisions to buy and to sell a particular corporate business have been made, the actual mechanics of the transaction must be negotiated between the parties. Although the specific circumstances attending each sale and purchase of a corporate business are unique, the fundamental approaches are relatively few: to effect the acquisition, the acquiring corporation may acquire either the assets or the stock of the targeted corporation, and it may do so using cash, notes, long-term debt, its own stock or its parent's stock, as consideration.

Characteristically, where cash and debt are used as consideration, the effect of the transaction is to divorce the seller's prospective economic fortunes from those of the disposed business enterprise. The tax law recognizes the fundamental economic significant of this event by mandating the seller's contemporaneous recognition of gain or loss. Of relevance here is of course, the fact that the frequent effect of these transactions is the substitution of outstanding corporate equity with corporate debt.

But if the consideration that is used by the purchasing corporation is instead either its own or its parent's stock, then the transaction may qualify as a nontaxable "reorganization" under section 368(a) of the Internal Revenue Code. In marked contrast to most taxable acquisitions, nontaxable acquisitive reorganizations—in that they generally mandate the exclusive or substantial use of corporate equity consideration—usually preserve the pre-acquisition level of corporate equity, vis-a-vis debt, outstanding. Consequently, where the personal, economic and tax objectives of the transacting parties incline them to structure the transaction as a nontaxable reorganization, and where, in these instances, the tax statute and administrative environment enable them to act on these inclinations, the resulting level of corporate equity is generally maintained.

Regrettably, there are substantial tax disincentives that operate to deter the use of nontaxable, equity-financed corporate acquisitions. Many of the tax disincentives, such as the deferral of corporate or shareholder-level loss, acquisition of low-basis corporate assets, and carry over of positive earnings and profits account balances, are the natural and expected consequences of according these transactions their tax-deferred status.

The other category of tax disincentive is not a natural, or necessary, by-product of tax deferral. Instead, these deterrents to equity-financed acquisitions are the result of the serious flaws that have historically plagued the rules governing qualification under section 368.

This body of law is, and has always been, replete with imperfection. Once frequent criticism is that radically different tax consequences often flow from alternative acquisition structures which, notwithstanding their technical distinctions, impart equivalent or near-equivalent economic effect to the participants. To date, this persistent and pronounced flaw in the statutory design has inexplicably failed to inspire remedial action on the part of Congress, and has been greatly exacerbated by the Treasury, the Service, and the courts through their uneven application of the often-recited tenet that substance should prevail over form in prescribing tax consequences.

There seems to me strong intuitive and anecdotal support for the proposition that—given the magnitude and nature of the tax risks which invariably attend nontaxable acquisition transactions, under the present regime; given the excruciating complexity and uncertainty of the tax statute; given the inevitable delay occasioned by the resultant need for advance letter rulings; given the public's awareness of the numerous unfortunate experiences of other taxpayers, who have inadvertently and unexpectedly become victims of this technical quagmire—many proposed equity-financed acquisitions are simply abandoned in favor of other alternatives.

In sum, I submit that the current rules and regulations governing the taxation of mergers and acquisitions, taken as a whole, fail to conform to generally accepted tenets of taxation, and that the technical distinctions that these rules make likewise do not conform with economic and marketplace standards. In my opinion, their most significant collective shortcoming is that they have created artificial distinctions between functionally equivalent transactional forms, and have permitted these distinctions to control important tax consequences in ways which unnecessarily compromise the legislative purposes that originally inspired and presently sustain these exceptional provisions.

My prepared statement illustrates the manner in which these defects have manifested themselves in the statute and suggests alternative approaches that might be of assistance in removing them.

The problems upon which my statement has focused are only a part of the larger issue being addressed in these hearings. I would submit that it is now generally recognized that this body of law has in its own right, long been in need of major reform. The pressures to debug these rules and regulations can be expected to increase now that the phase-out of *General Utilities* has been completed, and that equity-financed acquisitions, or at least the prospect of them, have therefore become more attractive.

Removing the many unwarranted deterrents to equity-financed acquisitions, now, could have the added benefit of assisting in the amelioration of some of the actual and perceived problems identified with debt-financed acquisitions.

Thank you.

[The statement of Mr. LaRue follows:]

Statement of David W. LaRue, Ph.D., Assistant Professor, McIntire School of Commerce, University of Virginia

INTRODUCTION

Mr. Chairman and members of the Committee, my name is David W. LaRue. I am an Assistant Professor at the McIntire School of Commerce at the University of Virginia. My comments and observations today derive from a recently-completed study funded by the Arthur Young and Co. Foundation, the Ralph E. Kent Fund, and the McIntire Associates Program.[1] I am not appearing on behalf of any special interest or group, and my opinions and conclusions do not necessarily reflect those of Arthur Young & Co. or any other organization. I have submitted a lengthy and detailed prepared statement and I will keep my oral remarks brief.

Corporate Mergers and Acquisitions

Once the decisions to buy and to sell a particular corporate business have been made, the actual mechanics of the transaction must be negotiated between the parties. Although the specific circumstances attending each sale and purchase of a corporate business are unique, the fundamental approaches are relatively few in number. To effect the acquisition, the acquiring corporation may, either directly or through a newly-created or previously-existing subsidiary, acquire either the assets or the stock of the targeted corporation. It may effect the acquisition using cash, notes, its own stock, stock of its parent corporation, or some combination of these, as consideration.

Taxable Acquisitions. Characteristically, where cash and debt are used as consideration, the effect of the transaction is to divorce the seller's prospective economic fortunes from those of the disposed business enterprise. The tax law recognizes the fundamental economic significance of this event by mandating the seller's contemporaneous recognition of gain or loss.

Of relevance here is the fact that the frequent effect of these transactions is the substitution of outstanding corporate equity with corporate debt. These transactions are, of course, the focus of the report prepared by the Joint Committee staff in preparation for these hearings, as well as that of most of this week's testimony.

Nontaxable Acquisitions. If, however, the consideration used by the purchasing corporation is instead either its own stock, or, where the acquiring corporation is itself a controlled subsidiary, its parent's stock, then the transaction may qualify as a nontaxable "reorganization" under IRC Section 368(a) if it otherwise conforms precisely to one of the statutorily defined nontaxable acquisition alternatives and to judicial interpretations of the legislative intent which originally inspired and presently sustains these provisions.[2]

In contrast to most taxable acquisitions, nontaxable acquisitive reorganizations--in that they generally mandate the exclusive or substantial use of corporate equity consideration--usually preserve the pre-acquisition level of corporate equity, vis-a-vis debt, outstanding. Consequently, where the personal, economic, and tax objectives of the transacting parties incline them to structure the transaction as a nontaxable reorganization, and where, in such instances, the tax statute and administrative environment permit them to act on these inclinations, the resulting level of corporate equity is maintained.[3]

There are substantial tax and economic disincentives which deter the use of nontaxable, equity-financed corporate acquisitions. Regarding the former, many of the tax disincentives, such as the deferral of corporate- or shareholder-level loss, acquisition [or preservation] of low-basis corporate assets, and carryover [or preservation] of positive earnings and profits account balances, are the natural and expected consequences of according such transactions their tax-deferred status.

The other category of tax disincentive is not a natural, or necessary, by-product of tax deferral. Instead, these deterrents are the result of the serious flaws that have historically plagued the statutory design and the administrative and judicial implementation of the rules governing qualification under Section 368. The taxation of corporate business combinations unquestionably ranks among the most complex and inextricable areas of contemporary federal income tax law. This body of law is, and has always been, replete with imperfection.[4] One frequent criticism is that radically different tax consequences often flow from alternative acquisition structures which, notwithstanding their technical distinctions, impart equivalent or near-equivalent economic effect to the participants.[5] To date, this persistent and pronounced flaw in the statutory design has inexplicably failed to inspire remedial action on the part of Congress, and has been greatly exacerbated by the Treasury, the Service, and the courts through their uneven application of the often-recited tenet that substance should prevail over form in prescribing tax consequences.

There seems to me strong intuitive and anecdotal support for the proposition that, given [1] the magnitude and nature of the tax and economic risks which invariably attend nontaxable acquisition transactions, [2] the excruciating complexity and uncertainty of the tax statute, [3] the inevitable delay occasioned by the resultant need for advance letter rulings, and [4] the public awareness of the numerous unfortunate experiences of other taxpayers, many proposed equity-financed acquisitions are abandoned in favor of other alternatives. I submit that it is now generally recognized that this body of law has, in its own right, long been in need of major reform. To do so at this time could have the added benefit of assisting in the amelioration of some of the actual and perceived problems identified with debt-financed acquisitions.

My comments today focus on the fundamental and congenital defects in the legislative design of the merger and acquisition tax statutes and suggest ways in which the current system might be made more congruent with generaly accepted tenets of taxation and with the economic realities attending corporate acquisitions.

FRAMEWORK FOR STATUTORY REFORM
OF THE
TAXATION OF CORPORATE MERGERS AND ACQUISITIONS

I would like to begin on a somewhat metaphysical plain by initially observing that one seemingly self-evident, but nonetheless critical, prerequisite to any conscientious attempt to identify and ameliorate deficiencies in the income tax system is the explicit recognition of the qualitative attributes which provide the framework for distinguishing "good" tax law from "bad" tax law. Yet, inexplicably, these attributes have never really been adequately identified, defined, or prioritized.[6] Nevertheless there seems to be a consensus that the federal income tax laws should be "equitable,"[7] their application "predictable,"[8] and that they be capable of efficient and effective administration. The legitimacy of employing the tax laws as a means of influencing social and economic behavior in ways which contribute to the fulfillment of non-revenue-generation objectives is generally, but by no means universally or unconditionally, accepted. And finally, few would contest the notion that the tax law should in all events be designed carefully so as not to inadvertently influence economic and social decisions in a manner which is detrimental to the best interests of the Nation.

I submit that the current rules and regulations governing the taxation of mergers and acquisitions, taken as a whole, fail to conform to these standards. In my opinion, their most significant collective shortcoming is that they have created artificial distinctions between functionally-equivalent transactional forms, and have permitted these distinctions to control important tax consequences, frequently in ways which unnecessarily compromise the legislative purpose [or purposes] that originally inspired and presently sustains these exceptional provisions.

The "Functional Neutrality" Criterion

"Functional neutrality," as I will use that term here, calls for impartiality in the tax recognition and treatment of acquisitions which are functional equivalents of one another.[9] Implicit in this criterion is the necessity of first identifying the legal and economic attributes which distinguish one acquisition or form of acquisition from another, and then isolating those differences which, for one policy reason or another, ought likewise to distinguish such transactions in the assessment of the income tax.

While the economic effects of acquisitions vary widely, as do the legal consequences attending each of the various acquisition techniques, a critical and comprehensive review of the legislative history of the reorganization provisions reveals that of such distinctions only a very select few have been recognized in the formulation or implementation of policy. And the relevance even of these few frequently varies substantially, often for no discernable reason, from one application to another.

Attributes Which Distinguish Corporate Business Combinations

Acquisitions may be distinguished from one another on the basis of the absolute and relative sizes of the amalgamating corporations, the identity of their respective shareholders and the extent to which the ownership of their stock is dispersed, and whether they are actively engaged in the conduct of a trade or business, or, alternatively, derive the bulk of their income from investment activities. Economists and regulatory agencies typically classify mergers as horizontal,[10] vertical,[11] or conglomerate[12] for the purpose of identifying transactions which might be expected to have a substantial impact on industrial concentration and competition. In some acquisitions, one or more of the corporations is financially distressed, while others involve healthy corporations with substantial earnings histories. Motive, that of the seller and/or the buyer, may also serve as a basis for classifying corporate business combinations. Finally, acquisitions can be distinguished on the basis of the ultimate effect of the transaction on the capital structure of the corporate participants and the size and identity of the post-transaction shareholders.

Of these distinguishing attributes, only four have generally proven meaningful in separating nontaxable mergers and acquisitions from taxable transactions. First, special rules are available to deal with some of the unique problems attending acquisitions of insolvent or bankrupt corporations.[13] Second, transactions in which the corporations are not engaged in the active conduct of a trade or business may run afoul of either Sec. 368(a)(2)(F), which withholds reorganization status from acquisitions involving certain investment corporations, or the continuity of business enterprise test set forth in Reg. Sec. 1.368-1(d). Third, the regulations and the courts invariably look to the principals and their motives to determine whether or not they were sufficiently inspired by "business purposes."[14] Finally, special rules sometimes pertain where the amalgamating enterprises have one or more shareholders in common.[15]

Attributes Which Distinguish Alternative Acquisition Structures

Acquisitions can be further distinguished on the basis of the method employed to carry them out. To effect the acquisition, the acquiring corporation [hereinafter "*A*"] may, either directly or through a newly-created or previously-existing subsidiary, acquire either the assets or the stock of the target corporation [hereinafter "*T*"]. It may do so using cash, notes, its own stock, stock of its parent corporation, or some combination of these, as consideration.

One example of an important nontax difference between these alternative acquisition structures relates to the exposure of *A* to the liabilities, particularly the contingent or unknown liabilities, of *T*. This exposure is *unlimited* if the acquisition is structured as a statutory merger or consolidation, while it is *limited* to *A*'s investment in *T* in a stock acquisition,[16] and, subject to important exceptions, is *nonexistent* where the acquisition is otherwise structured as an asset acquisition.[17] Other legal and economic factors that vary from one acquisition structure to another include: [1] preservation or loss of nontransferable franchise rights, contracts, leases, etc.; [2] mechanical aspects of effecting the transfer; [3] dilutive effect on the equity or voting interests of *A*'s shareholders; [4] shareholder approval and appraisal rights; [5] "purchase" v. "pooling of interests" method of accounting for the transaction in the financial statements; and [6] Federal security regulations and state blue sky laws.

While major differences do in fact distinguish one method of acquisition from another, a close examination of the legislative record covering the 67 years of the reorganization provisions reveals no instance where any of these factors--except indirectly and only to limited extent item [3], above--were expressly or implicitly recognized and consciously and deliberately selected as the basis upon which to apply different standards or to assess different tax burdens. Even insofar as equity/voting power dilution has provided a basis for mandating differing outcomes, neither the statute itself, nor the courts have considered relevant the economic significance of the actual resulting dilution. So long as the required amount and type of "equity" consideration is used to effect the acquisition, it matters not whether the shareholders of *T* wind up with any meaningful relative interest in *A* [or its parent] after the smoke clears.

The lack of functional neutrality in the legislative design is apparent when, for example, one compares the "solely for voting stock" requirement applicable to Type B reorganizations[18] with that applicable to Type C reorganizations,[19] and each of these to the corresponding rule applicable to the reverse triangular Type A reorganization,[20] and all three of these standards with the judicial and administrative interpretations of "continuity of interest" as applicable to the "straight" Type A reorganization.[21] One will search in vain for a reasoned explanation as to why the policy considerations supporting the basic notion of shareholder continuity in the context of corporate amalgamations should manifest themselves so differently from one transactional form to another. Similarly, note the "substantially all" requirement applicable to Type C reorganizations [and the "triangular" versions of the Type A reorganization], and the unexplained omission of any such discriminating criterion for nontaxable "straight" Type A reorganizations or for Type B reorganizations.

A sampling of the many other unexplained and counter-intuitive discrepancies in the legislative design includes:

[1] The statutory and administrative rules pertaining to the carryback of post-acquisition losses to pre-acquisition taxable incomes of *T*, *A*, and, where applicable, their respective affiliates, exhibit several incongruities[22]

[2] "Creeping" acquisitions[23] are generally permitted in a Type B reorganization and, to a lesser extent, a Type A reorganization, but are not allowed in either a Type C reorganization[24] or a reverse triangular Type A reorganization[25];

[3] *T*'s net operating loss carryovers following a stock acquisition are limited to the post-acquisition income produced by *T* and cannot otherwise be used to offset income produced by other corporations in the electing affiliated group. No such limitations are applied following nontaxable asset acquisitions;

[4] Direct payment of joint reorganization expenses by *A* in a Type B reorganization or a Type C reorganization is not viewed as the payment of consideration other than voting stock, whereas the equivalent alternative of paying cash to *T* for its use in paying such expenses is;[26]

[5] The rules governing the treatment of a taxpayer receiving "boot" in an otherwise nontaxable exchange fail to accord with economic realities. IRC Sec. 356(a)(1) requires that any realized gain be recognized to the full extent of the amount of boot received. Under Sec. 356(c), a realized loss cannot be recognized notwithstanding the receipt of boot by the shareholders. Because these rules do not provide for the recognition of gain or loss as a function of the extent of the shareholder's continuing proprietary interest, a shareholder receiving a relatively small amount of boot may be required to recognize most or all of his or her gain, while a shareholder receiving a substantial amount of boot would be denied any deduction for a realized loss[27]; and

[6] The "80% control" threshold applicable in a Type B and a reverse triangular Type A reorganization is itself an inconsistency in that the distinction it creates between acquisitions that meet or exceed this requirement and those that do not is not grounded in economic or legal realities.[28] Under local law, for example, ownership of stock possessing more than 50% of the outstanding voting power is usually sufficient for the shareholder to control the composition of the board of directors, and consequently the management, of the corporation. But a higher degree of control, usually 2/3, may be necessary under local law for a stockholder to unilaterally approve a merger, a sale of the corporation's business assets, or the corporation's liquidation. Similarly, generally accepted accounting principles usually consider 20%[29] and 50%[30] control thresholds to be relevant in the presentation of financial statements.

Because these distinctions serve no apparent policy objective, they create unnecessary traps for taxpayers who either fail to obtain competent professional tax advice, or who, notwithstanding advice of the highest calibre, fail to anticipate subsequent events which render the original decision unsound in terms of its ultimate tax effect. Even where all factors are identified, the law, again for no apparent policy reason, frequently forces the taxpayers to structure the transaction in a manner that does not optimally accord with their economic and financial objectives,[31] or to abandon the proposed acquisition altogether.[32] It is also likely that the resulting high degree of uncertainty associated with extrapolation,[33] coupled with the invariably high tax stakes that attend most corporate acquisitions, has discouraged innovation and adaptation to changing economic and financial environments,[34] and has thus impeded the natural, and generally healthy, evolutionary process.

This undesirable state of affairs derives largely from a historical failure to adhere to the functional neutrality criterion in both the design and the implementation of the merger and acquisition statutes. While there are several substantial legal and economic attributes which distinguish one acquisition or method of acquisition from another, only those that operate to enhance the fulfillment of the policy objectives supporting the special tax treatment accorded statutory reorganizations, and those that detract therefrom, should be referenced as the basis for assessing differential tax consequence. This is the essence of the problem: the merger and acquisition statutes have been permitted to evolve without the benefit of a coherent and unambiguous statement of the objective or objectives that the technical rules are intended to achieve.

Formulation Of An Unambiguous Statement Of Purpose: A Prerequisite To The Meaningful Reform Of The Merger and Acquisition Statutes

Taxation is, of course, a man-made phenomenon and is thus not grounded in any irrefutable law or laws of nature as are the natural sciences. If there is to be a solid foundation of precepts within which the U.S. federal income tax laws are to be constructed, that foundation must, in the final analysis, derive from Congressional deliberation and approval. Unfortunately, Congress has never undertaken such a task. Instead, the present income tax system is to a very large extent the product of our democratic form of government: the cumulative composite of a multitude of debatable judgements and political compromises.[35]

The foundation upon which the reorganization provisions have been constructed is, if anything, less solid than that of the tax law generally. A close examination of the legislative history of the reorganization provisions fails to reveal a coherent and unambiguous rationale to support the tax preference accorded these transactions. Nevertheless, several "theories," some arising from practical considerations, others resulting from economic or quasi-economic reasoning, have been advanced as justification for the special tax treatment of reorganization transactions.[36] None of these theories, however, presents an entirely accurate and unambiguous description of the philosophy and purposes underlying the reorganization provisions Since different technical rules would be required to accomplish different objectives, the lack of a clear statement of purpose has inevitably been productive of inconsistency and uncertainty.

"Wherewithal-To-Pay" As A Basis For The Reorganization Provisions

One line of reasoning, based upon readily apparent practical grounds, is that only the receipt of cash [or its equivalent] should be viewed as income because: [1] the cash concept of income is close to the layman's idea of income, [2] it is an approach that is easily administered, and [3] since the tax must be paid in cash, cash is the best measure of ability to pay.[37] Where the taxpayer receives only stock or securities in a reorganization, the argument continues, no tax should therefore be imposed on him.[38]

But the general rules of taxation, to which the reorganization provisions are exceptions, tax receipts without regard to whether or not they are in cash.[39] Consequently, this wherewithal-to-pay notion, though useful, leaves unanswered the question: Why does the law apply this more lenient doctrine to some favored exchanges while denying it to others?[40]

"Strict Continuity of Interest" As A Basis For The Reorganization Provisions

Another theory, which will be referred to here as the "strict" continuity of interest theory, holds that while gain or loss resulting from a reorganization may have technically accrued, the stocks or securities received in the transaction are, in substance, identical or nearly identical to the stocks or securities given up. The ultimate economic outcome of the original investment thus remains conjectural in that the taxpayer has not, in reality, ". . . 'cashed in' on a gain, or closed out a losing venture."[41] Consequently, the as-yet speculative nature of any technically realized gain or loss should preclude its contemporaneous recognition.

This was the announced purpose underlying the earliest reorganization legislation: "to negative the assertion of tax in the case of certain purely paper transactions"[42] and to thereby provide for transactions which were "merely changes in form but not in substance."[43]

While the strict continuity of interest doctrine may explain why some forms of reorganization [such as the classic Type E or Type F] are not deemed taxable events,[44] it fails to account for the nontaxability of other forms, notably combinations or divisions of corporations. The corporate-level and shareholder-level changes generally occasioned by these types of transactions, measured by economic and marketplace standards, are unquestionably substantial and not merely formal.[45]

"Substantial Continuity of Interest" As A Basis For The Reorganization Provisions

The "substantial" continuity of interest theory, though related, is conceptually distinct from the strict continuity of interest theory described above. At first glance, the only difference between the two appears to be one of degree. But under the strict continuity of interest theory, the function of the reorganization provisions is that of a folderol: they are nothing more than explicit statutory recognition of the implied notion that substance should dominate form in determining whether a transaction produces constitutionally taxable "income." Conversely, under the substantial continuity of interest doctrine, the reorganization statutes become exemptions legislatively bestowed upon transactions which indisputably produce income in a constitutional sense, transactions in which what is received is not identical or even substantially identical in form or in substance to that which is given up:

> The purpose of the reorganization provisions . . . is to except from the general rule [of immediate taxation] certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a *readjustment of continuing interest in property under modified corporate forms.* Requisite to a reorganization . . . are a continuity of the business enterprise under modified corporate form, and . . . *a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization.*"[46]

Thus, under the substantial continuity of interest doctrine, the purpose of the reorganization provisions can be viewed as the manifestation of Congressional intent to grant exemption where [1] the taxpayer's investment is still in corporate solution and [2] the taxpayer's interest in the assets and business of the old corporation before the transaction, though significantly modified, is nevertheless "substantial," i.e., "definite and material,"[47] after the transaction.[48]

Of all the theories advanced as justification for the special tax treatment of corporate reorganizations, this theory seems to be most reflective of Congressional intent. But notwithstanding its strong intuitive appeal, the general notion of substantial continuity of interest lacks the specificity capable of producing consistent operating standards.[49] First, it does not identify the characteristics of an economic interest in *A*'s fortunes which are to be referenced to determine whether any measure of continuity has been conveyed to the holder. In the context of a Type B or a Type C reorganization, for example, all of *T*'s shareholders, even those originally holding nonvoting stock, must exchange their stock for *voting* stock of *A*. Yet in a Type A reorganization, nonvoting, nonparticipating preferred stock has been held to possess the capacity to impart the requisite continuity to its holder, even where that shareholder originally held a fully-participating, voting interest in *T*.

The general notion of substantial continuity of interest also fails to identify the appropriate reference point for measuring the degree of continuity and testing the sufficiency thereof. To implement legislative intent, should taxable and nontaxable transactions be distinguished on the basis of [1] the degree to which *T*'s former shareholders convert their equity into that of *A*, or [2] the relative interest in *A* which *T*'s shareholders wind up with, or [3] some combination of both? Should these standards be applied on an individual, shareholder-by-shareholder basis, or should they be applied by reference to the group of shareholders, with the results binding on all members of that group? What attribute or attributes of equity ownership should be referenced in taking these measurements: the degree of continuing voting power and/or participation in future profitability, or simply the value of *A*'s equity?

Alternatively, or additionally, should "continuity" be tested at the corporate, rather than at the shareholder, level? And if so, what attributes should be referenced as the relevant measure of corporate continuity: continuation of business enterprise, continued use of historic business assets, continuity of legal entity, or all, or a combination, of these?

An even more fundamental issue, which has been raised only recently, is whether continuity of the corporate entity should be separated from the continuing participation of its shareholders, so that that these respective components of the transaction are to be evaluated and taxed independently of one another.[50]

In my opinion, each of these competing perspectives is viable within the context of the general statement of purpose set forth in Sec. 1.368-1(b) of the regulations, and none seems to possess virtue of a relative magnitude sufficient to render the others clearly subordinate. Consequently, if "substantial continuity of interest" is to serve as the touchstone for the identification and isolation of worthy transactions, only an unambiguous statement as to just what the phrase is intended to mean can avoid the inconsistencies and uncertainties that have proliferated in its absence.

Removing Impediments To Business Growth and Expansion As A Basis For The Reorganization Provisions

The reorganization provisions have also been supported on the grounds that, by removing many of the adverse tax effects, they restore a necessary degree of neutrality to the decision processes of those whose economic circumstances either require or might be enhanced by such transactions.[51] This final approach goes beyond mere questions of tax law and tax equity to view mergers and acquisitions as essential to the proper functioning of these activities in the economy.[52] If the sole or principal rationale for awarding tax deferral is to foster mergers and acquisitions by removing tax-related impediments, one would expect the technical rules supporting this objective to be much more permissive than those designed to distinguish transactions on the basis of continuity of interest. One would also expect to find some mechanism for distinguishing between amalgamations which are "good" in a societal sense, and those that are not. While a number of tax provisions have been designed to eliminate "unwarranted inducements to mergers,"[53] and while this committee is presently considering others, the task of discouraging and preventing mergers, the likely impact of which is considered detrimental to the economy, has been, to date, largely delegated to the anti-trust division of the Department of Justice and to the Federal Trade Commission.[54]

Framework For Analysis:
The Reorganization Provisions

In sum, there does not at present exist a coherent system of unambiguous objectives and fundamental precepts which are capable of producing consistent operating standards. Regrettably, even the laudable, and in other respects, comprehensive, effort of the Staff of the Senate Finance Committee in recommending changes which would overhaul the present statute fails to address this very fundamental problem.[55] In my view, unless and until Congress identifies and prioritizes the specific objectives that the exemption awarded to mergers and acquisitions are intended to achieve, there is simply no basis upon which to definitively evaluate conflicting notions as to how the system might best be improved. Even the most cursory review of the judicial conflicts that this body of law has given rise to reveals that, in the absence of an unambiguous reference point, the essential nature of the opposing arguments of the litigants is uncomfortably analogous to the medieval debate as to how many angels could dance on the head of a pin.

Additionally, it is my view that *functional neutrality should be the standard for evaluating both the adequacy of the statutory implementation of tax policy objectives and the validity of subsequent administrative and judicial interpretations.*[56] Once the objectives have been unambiguously stated, it is the duty of the legislators and their staffs to identify attributes which either enhance or detract from those objectives.[57] Absent overriding administrative considerations, the statute should be designed so as to affirmatively discrimminate between alternative courses of action on the basis of whether they possess or fail to possess such attributes. It should be neutral as to the presence or absence of attributes which neither enhance nor detract from the fundamental objective.

Clearly, perfection is unattainable. But it is the frequent failure to embark on its quest which has resulted in so much uncertainty and inconsistency, and which has thus contributed so greatly to the erosion of the tax system's credibility.

CONCLUSION

In sum, the rules and regulations presently governing equity-financed mergers and acquisitions fail to conform to generally accepted tenets of taxation or to economic and marketplace realities. They create unnecessary traps for taxpayers who either fail to obtain competent professional tax advice, or who, notwithstanding advice of the highest calibre, fail to anticipate subsequent events which render the original decision unsound in terms of its ultimate tax effect. Even where all factors are identified, the law frequently forces the taxpayers to structure the transaction in a manner that does not optimally accord with their economic and financial objectives, or to abandon the proposed acquisition altogether. It is also likely that the resulting high degree of uncertainty associated with extrapolation, coupled with the invariably high tax stakes that attend most corporate acquisitions, has discouraged innovation and adaptation to changing economic and financial environments, and has thus impeded the natural, and generally healthy, evolutionary process.

In my view, this undesirable state of affairs derives largely from a historical failure to adhere to the functional neutrality criterion in both the design and the implementation of the merger and acquisition statutes.

The problems upon which my statement has focussed are only a part of the larger issue being addressed in these hearings. But as I noted earlier, it is now generally recognized that this body of law has long been in need of major reform. To do so at this time could have the added benefit of assisting in the amelioration of some of the actual and perceived problems identified with debt-financed acquisitions. In this regard, the thoughtful observations, analyses, and conclusions of the many commentators who have explored this body of law could go a long way in helping to remove the many impediments and deterrents that presently operate to quell necessary and deserving equity-financed mergers and acquisitions.

Thank you. This concludes my remarks and I will be happy to respond to any questions.

ENDNOTES

[1] The results of this study were published in LaRue, David W. "A Case For Neutrality In The Design and Implementation Of The Merger And Acquisition Statutes: The Post-Acquisition Net Operating Loss Carryback Limitations," 43 *Tax Law Review* (Fall, 1987): pp. 85-240, the last 25 pages of which, condensed and modified, comprises the majority of my prepared statement.

[2] Very generally, the tax laws view acquisitions meeting these criteria as merely an intermediate step in an ongoing business or financial venture, rather than as the termination of one such activity followed by the initiation of another. Consequently, corporate and shareholder-level gain and loss is deferred [via statutorily-mandated basis adjustments] and the tax attributes of the acquired corporation are generally preserved. IRC Secs. 354, 356-8, 361-2, 381-4, 269.

[3] This general statement must be tempered by the reality that in many nontaxable transactions dissenters of one or both of the amalgamating corporations exercise their legal rights to have their stock judicially appraised and redemed for cash or debt. On the other hand, the creditors of the target corporation frequently desire [and are permitted] to convert their target corporation debt into the equity of the acquiring corporation tax-free.

[4] Randolph Paul, the noted tax attorney and educator, once observed in connection with the reorganization provisions:

"There is something wrong with provisions which remain so obscure, in spite of filigree detail in the statute and the regulations, that hardly any prediction as to their meaning can be made without the feeling that it is little better than a dignified guess." Paul, Studies in Federal Taxation 164 (1940).

For more contemporary statements as to the principal shortcomings of the tax law governing mergers and acquisitions, see Staff of Senate Committee on Finance, *Report on the Subchapter C Revision Act of 1985*, 99th Cong., 2d Sess. 3, 37-49 (1985) [hereinafter *Revision Act Report*]; Wolfman, Continuity of Interest and the American Law Institute Study, 57 *Taxes* 840 (1979).

[5] See, e.g., *Revision Act Report*, note 4. But not all commentators share this concern. See Jacobs, Reorganizing the Reorganization Provisions, 35 *Tax Law Review* 415 (1980).

[6] In "The Wealth of Nations," Adam Smith proffered four maxims of taxation: that taxes should be equitable, certain, convenient to pay, and economical to collect. A. Smith, *The Wealth of Nations* 777-79 (Modern Lib. ed. 1937]. For a more contemporary view as to the function of our income tax system see Eustice, Tax Complexity and the Tax Practitioner, *California CPA Quarterly* 10, 11 (Sept. 1976).

[7] The concept of "equity," as it pertains to taxation, is multifaceted. "Horizontal equity," for example,

requires that taxpayers of comparable economic circumstance bear correspondingly comparable tax burdens. The complementary, and generally accepted, notion of "vertical equity" suggests not only that taxpayers of dissimilar economic circumstance bear dissimilar relative tax burdens, but also that the relationship between them be direct, rather than inverse.

Because "economic circumstance" is a function of several complex and interrelated variables, such as income, wealth, family size, health, education, etc., one obvious impediment to the attainment of the ideal is the difficulty, perhaps impossibility, of capturing and quantifying this elusive and somewhat abstract phenomenon in a manner that renders it susceptible to unambiguous ordinal ranking. Even then, the mathematical function manifesting the "optimum" [i.e., "most equitable"] relationship between such measures and different magnitudes of tax burden could not, of course, be derived from, or proven by reference to, the physical laws which sustain order in our universe. The numerous and diverse features of the income tax law which, collectively, have in fact given us some measure, albeit an unquantifiable measure, of "vertical equity," have instead been distilled from the wide range of complex, subjective, and ever-changing value structures and political philosophies by the obscure processes which inevitably culminate in political compromise.

Finally, the equity cannon would also seem to require that every effort be made to design and administer the law so as to minimize the potential injustices which might otherwise be inflicted upon unwary taxpayers as a result of technical requirements and distinctions that are unduly harsh, or which simply serve no legitimate function, vis-a-vis policy objective, and are therefore arbitrary and, frequently, counter-intuitive. This facet of tax "equity" is closely related to the "functional neutrality" criterion, which is defined, discussed, and illustrated in the pages that follow. In marked contrast to the "horizontal" and "vertical" facets of equity, the pursuit of this ideal is constrained less by factors over which the policymaker has little or no control, than by lack of willingness and insight.

[8] "Predictibility" also has both static and dynamic dimensions. In the former sense, the term refers to what might be labelled the "ambiguity coefficient" of a particular provision or grouping of related provisions: i.e., to what extent is the legislative design, supplemented perhaps by administrative pronouncement, capable of prescribing unique, unambiguous, predictible outcomes for the transactional patterns that fall within its purported scope? At one extreme, Sec. 443 [short period returns], which provides definitive mechanical rules and formulae to cover virtually every conceivable circumstance, might be considered to have an unusually low ambiguity coefficient, while that of the provisions governing corporate acquisitions would be considered by most to be abnormally, and undesirably, high. Clearly, the maximum acheivable level of predictability will vary from one area of the law to another, and can generally be expected to do so as a function of such things as the number of variations and permutations which comprise the universe of covered transactions, the extent to which mathematical formulae and objective criteria can be substituted for elusive "fact and circumstance" criteria without unduely compromising legislative purpose, whether or not taxpayer motive and intent is to be a distinguishing factor, and so forth. It should be noted also that the pursuit of greater predictibility must frequently be tempered by an awareness of the additional complexity which omniscience invariably begets.

Predictability over time is likewise generally recognized as a desirable attribute of a tax system. In this regard, attention focuses not only on the frequency, scope, and magnitude of change, but also on the transitional mechanisms selected for its implementation. To many, perhaps most, observers, the recent history of the U.S. income tax system has evidenced considerable legislative indecision, and, all too frequently, an incongruent, but nonetheless impassioned, urgency regarding the implementation thereof. Not only have businessmen, investors, and other taxpayers had to deal with near-exponential rates of change in the tax law throughout the past two decades, they have also had to contend with an increasing propensity on the part of legislators to implement these changes "retroactively." A change in the tax law can be considered "retroactive" if, as a result of the change, taxpayers either suffer unanticipated losses or reap unanticipated gains as a result of irrevocable pre-change commitments of resources [or binding executory commitments of future resources]. These economic gains and losses may result from--

1. Changes in the tax liabilities attributable to income or loss economically "accrued" in the past but not yet recognized for tax purposes as of the effective date of the change,
2. Tax-induced changes in the market value of assets owned by the taxpayer,
3. Tax-induced changes in the magnitude of the economic burden of the taxpayer's outstanding liabilities, or
4. Retroactive changes which simply confiscate wealth legally earned, where the change is not the result of a legitimate need to correct actual or perceived ambiguities, and where it does not constitute the exercise of discretion or the resolution of contingincies expressed or implied in the relevant statutes.

[9] The concept of tax "neutrality" is by no means a new one. Professor Groves, perhaps one of the first commentators to explicitly isolate and define this concept, and to distinguish it from "equity", described neutrality in the following terms:

> "Neutrality . . . calls for impartiality of treatment. The partiality that we are concerned with may arise from: [1] unequal treatment of essentially similar taxpayers; or [2] the same treatment of essentially different taxpayers. Discrimination may be deliberate or inept. Its curse is removed when it is supported by adequate public purpose and ample prospect for achieving that purpose.
> "The term 'neutrality' as thus defined differs from 'equity' . . ., which include(s) an interest in economic equality as well as in impartiality. Thus taxes are said to be equitable when they make for a more even distribution of economic reward. Neutrality has to do less with the standards applied to the over-all distribution of the tax load and more with the even application of those standards once they are chosen. There is no inference of conflict between the two cannons. The thought is not that taxes should be neutral *rather than* equitable; they should be both. Or perhaps more accurately: taxes should be equitable and they should deviate from neutrality only for adequate public purpose."

Groves, Harold M., "Neutrality In Taxation," *National Tax Journal* 1 (March, 1948): 18-24 at p.18.

The complementary, but distinct, notion of "*functional* neutrality," calls for impartiality at a level different than that implicit in the unqualified term. Once a class of transactions has been designated for partial treatment, the relevant inquiry becomes: Are all transactional variations which achieve the "public purpose" supporting the initial departure from neutrality themselves treated impartially *inter se*? Conversely, are those transactional structures which fail to evidence the achievement of that purpose denied the benefits [or spared the detriments] of discrimination? Consequently, "functional neutrality" has little, if anything, to do with the formulation of policy, and everything to do with the design of rules intended to implement policy once formulated.

Clearly, as noted later in the text of this section, the motives and purposes which inspired partiality should be of paramount concern in constructing "functionally neutral" operative provisions. Without such a reference point, attempts to distinguish "good" from "bad" will invariably lack the precision which Professor Groves seemed to have had in mind when he qualified the terms under which discrimination could be tolerated. Again: "Its curse is removed when it is supported by adequate public purpose *and ample prospect of achieving such purpose*." [Emphasis added.]

[10] In a "horizontal" merger, the products of the amalgamating enterprises have a high cross-elasticity of demand, i.e., the marketplace views such products as more or less substitutable.

[11] In a "vertical" merger, the product or services of one of the corporations is either sold by or used as a production input by the other.

[12] A conglomerate merger involves corporations that are neither "vertically" nor "horizontally" related. A conglomerate merger results in an enterprise that is diversified as to the geographical or the product markets that it supplies.

[13] IRC Sec. 368(a)(1)(G).

[14] Reg. Sec. 1.168-1(b), (c). See also Sec. 269, which looks to the relative intensity of business and tax-avoidance motives where both are present.

[15] E.g., Sec. 368(a)(1)(D), 354(b), 368(a)(1)(F). The tax law also provides special definitions and rules for the tax treatment of sales or exchanges to effectuate policies of the Federal Communications Commission [IRC Sec. 1071]; exchanges in obedience to orders of the Securities and Exchange Commission [IRC Sec. 1081-1083]; and distributions pursuant to the Bank Holding Company Act [IRC Sec. 1101-1103].

[16] Shareholder warranties and contingent and escrow consideration arrangements, however, can be and

frequently are used to minimize these risks in both statutory mergers and consolidations and stock acquisitions. Rev. Proc. 77-37, Section 3.06, 1977-2 C.B. 568, sets forth advance ruling criteria for the use of contingent and escrowed stock consideration in nontaxable corporate acquisitions Type A, B, and C reorganizations.

[17] *A*, in a non-statutory merger or consolidation, could inherit some or all of *T*'s liabilities due to [1] noncompliance with the applicable state Bulk Sales Act, [2] payment of the purchase price directly to *T*'s shareholders rather than to *T* itself, or [3] by application of the judicial de facto merger doctrine, as articulated, for example, in *Heilbrunn v. Sun Chemical Corp.*, 150 A.2d 755 (Del. Sup. Ct. 1959).

[18] IRC Sec. 368(a)(1)(B).

[19] IRC Sec. 368(a)(1)(C), (a)(2)(B). IRC Sec. 368(a)(1)(C) provides: "in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded."

IRC Sec. 368(a)(2)(B) further allows consideration other than voting stock in a Type C reorganization where at least 80% of the gross fair market value of *T*'s assets have been acquired for voting stock.

[20] IRC Sec. 368(a)(2)(E)(ii). In a reverse triangular Type A reorganization, the voting stock of the parent corporation must be used to acquire at least 80% control, as defined in Sec. 368(c), of *T*; but there are no restrictions as to the type of consideration that may be used to acquire any stock in excess of that amount.

[21] For advance ruling purposes, if *T*'s shareholders, as a group, receive equity [voting or otherwise] equal in value to 50% or more of all of the formerly outstanding *T* stock, continuity of interest generally is deemed satisfied. Rev. Proc. 77-37, Section 3.02, 1977-2 C.B. 568. Some courts, including the Supreme Court, have been even more permissive; e.g., *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) [where the court found sufficient continuity of interest although the *T* shareholders received 62% cash and only 38% nonvoting preferred stock].

[22] In terms of their adherence to the functional neutrality criterion, the rules and regulations collectively governing the carryback of post-acquisition losses can be criticized on two counts. First, although the nature and extent of required shareholder "continuity" varies substantially from one statutory manifestation to another, the ultimate impact of the transaction on shareholder continuity is preeminent in distinguishing acquisitions for tax purposes. [The other dominant themes of the reorganization provisions are "business purpose" and "continuity of business enterprise.] Yet except in rare and unusual circumstances, the presence or absence of shareholder continuity makes no difference whatsoever. Consequently, on the one extreme, the pre-acquisition incomes of two corporations, owned at all times by the same shareholders in the same proportions, forever vanish when business concerns compel their statutory consolidation. Yet, at the other end of the spectrum, if *A* acquires *T* by purchasing all of *T*'s stock, resulting in a 100% change in *T*'s ownership, the law permits *A*, and indirectly its shareholders, to benefit from the restoration of taxes actually borne, in the ultimate sense, by *T*'s shareholders.

Second, where distinctions are made as the basis for applying different rules, it is clear that such distinctions are not relied upon consistently and that they have little to do with any of the fundamental themes forwarded to explain the acquisition rules. Indeed, an exhaustive search of legislative history has failed to produce any explicit or intuitive reasoning which might explain why, from a policy standpoint, the rules vary as they do: they seem to have been formulated without any coherent notion as to why they might be necessary in the first place.

For example, tax consequences aside, it usually makes absolutely no legal or economic difference which of the two or more corporations in a statutory merger is selected as the surviving corporation. Nevertheless, as the law presently stands, if the corporate entity chosen to be the transferor corporation happens to be the one with the substantial pre-acquisition taxable income, then, in the event of substantial post-acquisition losses, the surviving corporation, and indirectly all of its shareholders--even the late transferor corporation's continuing shareholders--are denied access to the refund potential that the prior taxable recognition of such income would have otherwise made possible. If the parties choose the legal and economic equivalent of statutory consolidation, then none of the pre-transaction taxable income of any of the transferor corporations would be available to generate a refund from a post-transaction net operating loss carryback. Further, if the corporations were commonly owned and the objective of the transaction was simply to report the incomes, gains, losses, deductions, and credits of the two corporations on a single tax return, this could have been accomplished tax-free by simply transferring the stock of the corporations to a newly organized holding company and filing a consolidated return. This alternative to a merger or consolidation would not, however, preclude the carryback of the corporations' respective post-acquisition losses to their own pre-acquisition tax returns. [Such carrybacks would, however, be subject to the SRY and/or SRLY rules set forth in the consolidated return regulations.]

A similarly unexplained and counter-intuitive lack of symmetry exists with respect to the requirement that losses, where they may otherwise be carried back, must sometimes, but not always, be traced to the income of the corporation that produced them. Recognizing the substantial support that exists for each of the opposing arguments as to the propriety of a *Stauffer/Libson Shops/SRY*-type tracing rule, it is by no means apparent that the rule is any more or less meritorious in the context of a stock acquisition than it is in an asset acquisition. [Interestingly, the same committee reports that repudiated *Libson Shops*, expressly approved the continued application of the SRLY limitations. S. Rep. No. 313, 99th Cong. 2d Sess., reprinted in 1986-3 C.B. (vol. 3) at 247.]

[23] A "creeping acquisition" is generally one in which *A* already holds an equity interest in *T* at the time a decision is made to increase its level of ownership in *T* by acquiring either additional *T* stock or *T*'s assets.

[24] See *Bausch and Lomb Optical Co. v. Comm.*, 267 F.2d 75 (2nd Cir. 1959), where a portion of the assets received by *A* was deemed to have been received in exchange for stock it already owned in *T*, rather than in exchange for its voting stock.

[25] The statute expressly requires that stock constituting at least 80% control must be acquired in the transaction itself. IRC Sec. 368(a)(2)(E)(ii). Consequently, if *A* already owns more than 20% of *T*'s stock, this requirement cannot be satisfied. But see Rev. Rul. 72-354, 1972-2 C.B. 216 for a "purge" technique that might sometimes be available to overcome this problem.

[26] Rev. Rul. 73-54, 1973-1 C.B. 187.

[27] Assume, for example, that shareholder *D* has a basis in her 100 shares of stock of $450,000, while shareholder *E* owns 100 shares of stock with a basis of $550,000. In a nontaxable Type A reorganization, *D* and *E* exchange their respective shares for $50,000 in cash and $450,000 worth of *A* stock. Consequently, each has drawn 10% of the current value of their original investment out of corporate solution. The economic realities of this transaction would thus dictate that *D* and *E* recognize 10% of their respective gain and loss. Instead, Sec. 356 requires that *D* recognize 100% of her gain [$50,000], while denying *E* any deduction for his legitimate and otherwise conclusive loss. Nowhere does the legislative record reveal why the fundamental notion of continuity of interest should be abandoned in favor of these decidedly punitive rules merely because the taxpayer's continuing interest is somewhat less than absolute.

This deficiency in the design of the rules pertaining to the recognition of gain or loss upon the receipt of boot is not limited to Sec. 356. See also, for example, Sec. 1031(b), (c); 1034(a). The mandatory treatment of taxpayers receiving boot in these otherwise nontaxable transactions is likewise irreconcilable with the economic realities which they were enacted to acknowledge.

[28] Prior to 1934, the predecessor to the Type B reorganization required only that at least a majority of *T*'s voting and nonvoting shares be acquired. Section 202(c)(2) of the Revenue Act of 1921; Section 203(h) of the Revenue Acts of 1924, 1926; Section 112(i) of the Revenue Act of 1928 and 1932. Without elaboration in the accompanying committee reports, the control requirement was increased to its current level by Section 112(g) of the Revenue Act of 1934.

[29] A 20% to 50% level of control usually requires the use of the "equity" method of accounting for an investment in a subsidiary. See *Accounting Principles Board Opinion No. 18*.

[30] Under GAAP, consolidated financial statements are usually considered appropriate where the parent corporation has greater than 50% of the voting control of the subsidiary.

[31] For example, assume that the objective of *A* is simply to acquire all or a part of *T*'s assets. Assume further that the target corporation's shareholders are unwilling to proceed unless the transaction can be structured as a tax-free reorganization. If the acquisition cannot be arranged so as to qualify as a Type C reorganization, either because the "solely for voting stock" requirement or the "substantially all" requirement cannot be satisfied, *A* may be forced to opt for a statutory merger. In so doing, *A* will be exposing itself to *T*'s contingent and inchoate liabilities. And, since state law generally requires that *A*'s own shareholders approve the merger, it may also incur substantial additional expense or delay in carrying out the acquisition if its stock is widely-held. This additional risk and expense can usually be avoided in a Type C reorganization.

Further, the complexities, ambiguities, and uncertainties which characterize these rules and regulations can also operate to produce windfall gains to one of the transacting parties to commensurate economic detriment of the other. This is because the tax benefits and detriments resulting from the anticipated tax characterization of the transaction are normally factored into the purchase price during the negotiation process. For example, if the assets of a profitable target corporation have appreciated substantially, *A* will usually benefit from circumventing the reorganization provisions by structuring the transaction so that it is fully taxable. By so doing, it will obtain a higher basis in the acquired assets [Sec. 1012 v. Sec. 362(b)] and will not inherit the target's pre-acquisition earnings and profits. Consequently, if *T*'s shareholders insist on a nontaxable acquisition to avoid the immediate recognition of their substantial gains, *A* will usually factor the expected tax detriment of the lower tax basis and the carryover of *T*'s earnings and profits account into their offer. If a transaction, originally thought to be nontaxable, is subsequently determined to have been taxable, then, unless there are contingency provisions in the purchase contract which provide for this possibility, one party stands to benefit to the obvious detriment of the other. Unfortunately, the excruciating complexity that has resulted from the lack of adherence to the functional neutrality criterion has made the risk of retroactive reclassification unnecessarily high: not only because of the difficulty associated with deciphering these rules and, where necessary, interpolating between them, but also because the numerous ultra-technical distinctions make it relatively easy for one of the parties to unilaterally trigger such a reclassification.

[32] For example, where business and legal considerations preclude the use of a statutory merger or consolidation as the means to effect the desired acquisition, *A*'s shareholders may view the dilution of control and equity that would result from compliance with the "solely for voting stock" requirement of the Type B and Type C reorganizations to be so unpalatable that the proposed acquisition is ultimately abandoned. Similarly, if *A* seeks the legal and economic attributes unique to the Type C reorganization, but finds that *T* owns a business or substantial assets that *A* does not wish to purchase [or which *T* does not wish to sell], the "substantially all" requirement might create an insurmountable impediment to the consummation of the proposed acquisition.

[33] The "logic" manifest in the reorganization provisions is antithetical to that evident in, for example, the algebraic "rule of transitivity," where if it is known that A=B and that B=C, then one may derive that A will in all events equal C.

[34] This brings to mind an old Ashanti proverb: "It is only the fool who tests the depth of a river with both feet."

[35] Eustice, note 6, at p. 12.

[36] In addition to the discussion which follows, see *ALI Federal Income Tax Project. Subchapter C: Proposals of the American Law Institute On Corporate Acquisitions and Dispositions and Reporter's Study on Corporate Distributions*, 155-159 (1982).

[37] In *Eisner v. Macomber*, 252 U.S. 189 (1920), the Court advanced several theories for holding that a stock dividend paid by a corporation in its own stock did not constitute income within the meaning of the Sixteenth Amendment. One of these, though certainly not the most important, was its recognition that a sale of the distributed shares to obtain the cash needed to pay the income tax would reduce the shareholder's voting power and decrease his or her capital interest.

[38] An early advocate of this approach was Robert H. Montgomery:

> "I do advocate an interpretation of the law which can be applied to actual income and actual gains . . . [T]hat is, as soon as the realization of income and gains becomes a fact and enough cash or the equivalent of cash is in sight to pay the tax."

Montgomery, Reorganization and the Closed Transaction, in *Federal Income Tax* 118, 121 (R. Haig, ed. 1921).

[39] See, e.g., Reg. Sec. 1.61- 1(a), 1.1001-1(a).

[40] Sandberg, The Income Tax Subsidy to 'Reorganizations', 38 *Columbia Law Review* 98, 100 (1938). Under a "cash flow" or "consumption" based tax system, all forms of savings and invested or reinvested income are excluded from the tax base. Such a system would adhere very closely to the wherewithal-to-pay concept of taxation and would therefore eliminate this inconsistency [and the need for many of the current reorganization provisions] entirely. See Treasury Dept., Blueprints for Basic Tax Reform (1977).

[41] *Portland Oil Co. v. Comm.*, 109 F.2d 479, 488 (1st Cir. 1939).

[42] S. Rep. No. 617, 65th Cong., 3d Sess. 4-5 (1918) [Senate Finance Committee Report explaining Section 202(b) of the Revenue Act of 1918].

[43] Gregg, Statement of the Changes Made in the Revenue Act of 1921 by the Treasury Draft and the Reasons Therefore, *New York Times*, Jan. 5, 1924 at 1, col. 2.

[44] Note, however, that even these reorganizational forms might not be--indeed, prior to express statutory sanction, were not--always nontaxable on the basis of strict continuity of interest. See *Marr v. United States*, 268 U.S. 536 (1925).

[45] Dane, The Case for Nonrecognition of Gain in Reorganization Exchanges, 36 *Taxes* 244 (1958); Hellerstein, Mergers, Taxes and Realism, 71 *Harvard Law Review* 254 (1957); Sandberg, note 40.

[46] Reg. Sec. 1.368-1(b) [emphasis added]. See also *Cortland Specialty Co. v. Comm.*, 60 F.2d 937, 940 (2nd Cir. 1932), where the court stated: "In defining 'reorganization', . . . [Sec. 368(a)(1)] gives the widest room for all kinds of changes in corporate structure, but does not abandon the primary requisite that there must be . . . some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption."

[47] *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 385-86 (1935).

[48] It is clear from a reading of even the earliest statutes that Congress had in mind the substantial continuity of interest doctrine [generally referred to simply as the continuity of interest doctrine], rather than their announced purpose of eliminating tax on "purely paper transactions." The courts were the first to articulate this implied purpose of the reorganization statutes. One commentator explained the reorganization exemption in the following terms:

> "[The] essence of a [statutory reorganization] is a continuance of the proprietary interests in the continuing enterprises under modified corporate form, the transaction being deemed insufficiently closed economically to justify a tax at the time, except in so far as the shareholder gets something in addition to stock or securities in the reorganized company."
>
> Darrell, The Scope of Commissioner v. Bedford's Estate, 24 *Taxes* 272 (1946) [quoted with approval by the First Circuit in *Lewis v. Comm.*, 176 F.2d 646, 648 (1st Cir. 1949)].

[49] For an excellent critical examination of the continuity of interest doctrine and its historical evolution, see Faber, Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?, 34 Tax Lawyer 239 (1981). For additional thoughts as to the deficiencies of this judicial doctrine and how they might be addressed, see DeCelles & Englebrecht, Safe Harbor Statutes for Solvent Corporate Reorganizations--A Qualitative Assessment, 61 *Taxes* 212 (1983); McGaffey & Hunt, Continuity of Shareholder Interest in Acquisitive Corporate Reorganizations, 59 *Taxes* 659 (1981); Wolfman, Continuity of Interest and the American Law Institute Study, 57 *Taxes* 840 (1979).

[50] See *ALI Federal Income Tax Project*, note 36, and *Revision Act Report*, note 4, at 50-53.

[51] Referring to Section 202 of the Revenue Act of 1921, the Senate Finance Committee report stated: "The preceding amendments, if adopted, will, by removing a source of grave uncertainty and by eliminating many technical constrictions which are economically unsound, . . . permit business to go forward with readjustments required by existing conditions . . . ." S. Rep. No. 275, 67th Cong., 1st Sess. 11-12 (1921).

[52] The desirability of removing obstacles to mergers and acquisitions has long been the subject of considerable controversy. In the legal literature, see Hellerstein, note 45 ; Cohen, Conglomerate Mergers and Taxation, 55 *American Bar Association Journal* 40 (1957). The economic literature is, of course, also replete with analyses of the effect of business combinations on industrial concentration and competition.

[53] H.R. Rep. No. 413, 91st Cong., 1st Sess., reprinted in 1969-3 C.B. 251, 263. See Sec. 269, 249, 279, 382, 384, 453(b)(3) [repealed], 1232 [repealed].

[54] But see Sec. 5881, added by the 1987 Act, which imposes a 50% nondeductible excise tax on gains that corporate raiders realize as a result of any "greenmail" payments they receive.

The American Institute of Certified Public Accountants persuasively argues that the tax law should not be used to regulate merger activity:

> "[W]here public policy does dictate that the interests of society are best served by preventing, limiting, or retroactively remedying a particular reorganization, the laws, regulations and sanctions employed to accomplish these objectives should arise solely from sources outside the tax law. If these laws, regulations, and sanctions are properly constructed and adequately enforced, there is simply no reason for the tax law to burden itself with concerns which properly lie far beyond the limits of its responsibility. Indeed, any reorganizations which remain to be dealt with for tax purposes [other than those whose dominant motivation is tax avoidance] would be desirable in a public policy sense and should therefore be facilitated, or at least not hampered, through the operation of 'neutral' taxing provisions."
>
> *AICPA Statement of Tax Policy Number 5: Taxation of the Formation and Combination of Business Enterprises* 4-5 (1979).

[55] Senate Finance Comm. Subchapter C Revision Act of 1985: Final Report, 99th Cong. 1st Sess. (1985).

[56] But not all commentators agree. See Jacobs, Reorganizing the Reorganization Provisions, 35 *Tax Law Review* 415, 416 (1980), where the author states:

> "Clear, simple answers will normally be favored, notwithstanding the recognition that long-held notions of equity or fairness might militate in another direction.
> "I believe in simplicity . . . . In its cause I am willing:
> "1. To concede the existence of anomalies;
> "2. To eschew the temptation to attempt to divine the 'right' answer; and
> "3. To accept the principle that the price one must pay for certainty and predictibility of result in tax-free corporate reorganizations is that form must be accorded an all but irrefutable presumption of governance.
> "Last, and perhaps most important, the temptation to compare and reconcile an endless variety of transactional forms yeilding irreconcilable tax results must be resisted. We should not permit our desire to treat substantively similar transaction~ similarly to become the touchstone of reorganization treatment."

It is not apparent to this observer that the relationship between functional neutrality and simplicity is inherently inverse. One has only to reflect upon the extraordinarily complex mathematical and natural phenomena that have been reduced to a relative few, relatively simple "givens," to query whether it might not indeed be possible to likewise reduce the complexities of the "endless variety of transactional forms" to a relative few attributes identified as relevant to the achievement of legislative purpose. Although this analogy is admittedly not very direct, it should nevertheless be clear from the preceding discussion that the more focused and unambiguous the stated objectives, the better able we are to discriminate between relevant and extraneous transactional attributes, and to thereby design a system of classification that is more, not less, generic in its orientation.

[57] It is abundantly clear that it is the task of the legislature, and not the courts, to establish the framework within which functionally-equivalent transactions can be taxed equivalently. See, for example, *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148-49 (1974); and *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75, 77-78 (2d Cir. 1959).

Mr. FORD. The Chair has several questions.

Mr. Ginsburg, you mentioned in your testimony that Congress should take a narrow legislative approach and stop some loss to the system through holdings by pension funds and foreigners of bonds that have original issue discount.

Do you think such a step would have a significant impact in reducing the equity reduction transactions?

If not, what do you think the Congress should do in regards to our severe revenue restraints that we are under here in the Congress.

Mr. GINSBURG. As my friend and colleague said at the outset of his talk, he is not an economist and I am not an economist either. I will try to respond as well as I can in light of my limitations.

It is not clear to me that at the moment the original issue discount debt problem is a major contributor to erosion of the corporate tax base. I think the serious risk is that very shortly it is going to grow enormously in size and scope.

I fear that, in part, because of developments that do have something directly to do with the tax law we have been seeing, for instance unbundled stock proposals, opportunities to—well, just to try more and more exciting things, I think it fair to say, with these kinds of instruments.

Therefore, I think if you don't do something to plug the hole, the hole is going to get larger and larger. That does have an enormous impact potentially on where the revenue will stand.

It seems to me, as Mr. Levin said, you can go at it, if you perceive it to be a problem, two ways. The narrowly tailored way is to say tax exempts will not hold this kind of paper because they will be taxed on yields they are not getting. I think that is a very efficient way to go about things.

The alternative is to say we will not allow the company to deduct the accruing but unpaid interest until it actually makes the cash payment. I have difficulty with that because I think it involves both substantial administrative problems and also creates the potential of all kinds of new tax avoidance planning.

Just think if being able to say that I get my deduction now or I get my deduction later, depending upon whom I encourage to hold this paper at a given time.

So I am not sure that I am fully answering your question, but I am sure that if I am not it is because I am incapable of doing more.

Mr. FORD. Mr. Levin, could you explain in greater detail how your second proposal dealing with interest in excess of a minimum rate would operate? Even though you wrote a book with Dr. Ginsburg, I am sure that he shares your approach, this enthusiastic approach of yours at that point. Can you explain that?

Mr. JACK S. LEVIN. While Dr. Ginsburg and I wrote a book, we argued a great deal about what to do and hopefully came to the right conclusions. We are not always of one mind.

In explaining the second proposal, it is a possible fine-tuning adjustment that I believe would not cause economic dislocation, but might improve the effectuation of the tax laws by putting a limit on the amount of interest that is deductible, for example, eight points over the rate payable by the Treasury on debt with a comparable maturity. It is very difficult to tell the difference between debt and equity, because it is, after all, a continuum, instruments are complicated, there are many complex financial instruments out there, hundreds of different types. One might rationally come to the conclusion that there is a certain limit on how much should legitimately be called debt and interest.

By putting a limit such as eight points over the comparable maturity Treasury rate, you would treat the excess as nondeductible, in the nature of a dividend. I do not believe it would be appropriate to taint the entire debt instrument because the yield went over the limitation. That would be placing too much weight on a very difficult to apply standard.

If a debt instrument paid eight and a quarter points and this tainted the whole instrument, it would be like falling off the edge of a cliff. But rather, it might be appropriate to disallow the interest deduction on only the excess yield, or alternatively, to impose a tax on the holder who might be a tax-exempt entity on only the excess yield rather than allowing its exemption to shield the entire yield on such a high yielding instrument.

This type of a tax law change would, in my view, not result in a severe economic dislocation, but rather would be the kind of fine-tuning change that would cool but not freeze legitimate transactions.

Mr. FORD. Is that all of the fine-tuning proposals you would have to avoid some of the abusive situations that we might be faced with?

Mr. JACK S. LEVIN. That was the second. I mentioned four in my testimony that I thought were worthy of consideration by this committee. The first was the deduction for accrued but not paid interest to the extent that it is paid to tax exempt recipients.

The second is the ceiling on interest deduction.

The third is reconsidering the encouragement through the tax law of ESOP borrowing. I am not saying anything adverse about the use of ESOP's themselves, which are a fine instrument. But ESOP's do participate in the leveraged buyouts that are going on now.

There is a fourth discussed in my testimony.

Mr. FORD. Mr. Levin, the total number of ESOP-LBO transactions is very small, are they not?

Mr. JACK S. LEVIN. I am not in a position to tell you how many. I am in a position to tell you that a fairly significant number of either leveraged buyouts or leveraged restructurings have utilized ESOP's.

Some utilize ESOP's to buy 100 percent of the company, some buy 30 percent of the company. The tax law currently gives a number of incentives for ESOP's to borrow large amounts of money with which to buy stock.

First, there is an exemption from capital gains tax for the seller. Second, there is an exemption from estate tax for an estate that is selling stock to an ESOP.

Third, there is a reduced rate of tax on the interest income to the bank which lends money to the ESOP. Fourth, there is a deduction for the sponsoring company when it repays both principal and interest on the ESOP's borrowing. And fifth, there is a tax deduction for the sponsoring company when it pays dividends on stock held by the ESOP.

Mr. **Ford**. I was under the impression that the ESOP-LBO transactions in general made up a smaller percentage; maybe somewhere between 2 and 3 percentage points of the LBO's?

Mr. **Jack S. Levin**. I am not in a position to comment on the percentage. I suspect the percentage would be higher if you took into account not merely those companies that were totally acquired by an ESOP, but also those where the ESOP borrowed money to buy 20, 30, 50 percent of the company's stock.

All I am saying is that if you reexamine the tax benefits of leverage generally, it would be worthwhile to reexamine these ESOP tax incentives which encourage greater borrowing. They are part of the borrowing now going on, whether they make up 3 percent or 13 percent, I don't know.

The fourth fine-tuning proposal discussed in my testimony focuses on the fact that a large, or at least a significant percentage of highly leveraged securities are purchased by investors, namely, tax-exempt entities and foreigners who do not pay U.S. income tax, or pay a drastically reduced rate on their earnings, and might focus on whether those entities should now be taxed at full U.S. rates on their profits from the holding of such highly leveraged securities.

Mr. **Ford**. The Joint Committee, Tax Committee, acknowledges the small role of ESOP's in LBO transactions. At page 73 of the committee pamphlet on LBO's reads in part, "It is not clear what percentage of leverage buyouts involve ESOP's. However, some evidence indicates that ESOP's are used in a relatively small number of transactions."

I guess the characterizations of the ESOP incentives is also a question of whether it is supported with fact. The OMB and the Joint Tax Committee tax expenditure estimates are very modest on ESOP's.

It is between $1 and $1.5 billion over 5 years for all ESOP incentives, which we are talking about a relatively small percentage point.

I guess of the more than $650 billion in capital financing, ESOP financing is barely a blip on the radar screen compared to what we have here with the leveraged buyouts.

I notice that you, Mr. Levin, and Dr. Ginsburg both have talked about the ESOP's in your testimony today.

Mr. **Ginsburg**. Could I hazard a comment that maybe Jack will follow up. It is all a moving target out there, Mr. Ford.

Just as in the OID area, about which you asked me earlier. What people did yesterday is not what we are afraid they are going to do tomorrow. Tomorrow is the unbundled stock transactions in which there is a magic incantation of paper and all of a sudden tremendous deductions are annually taken by corporations with nobody paying taxes on the other side.

In the ESOP area, I think the greatest moving target concern is a realization out there that you may be able to use ESOP's for something that we have not thought of before

This involves, for example, section 203 of the Delaware general corporation law, which is sort of a complicated piece of business.

Under it, if we initiate a 15 percent change in stock ownership, we may be able to mount, if we are management, an interesting defense to unwelcome takeovers.

One thing—I look at Jack because he understands these things better than I do—a company has used an ESOP as a place to put 15 percent of its stock for the purpose of obtaining that better position in the takeover dispute.

Once that sort of planning starts, people say, good, what other advantage can I take of our ESOP?

Yesterday's 3, 4 or 5 percent can in a very short period turn into something quite exciting. There is a general notion, I think, among tax people that the only reliable rule in these affairs is the All the People in China rule. If in year 1 somebody finds an interesting idea and in year 2, 14 people follow up on it, in year 3, there will be 85,000 transactions. And if you don't stop it at that point all the people in China will move to the United States and do this deal.

Mr. FORD. You claim ESOP incentives are so generous. If that is the case, why is it you don't see more ESOP's in the LBO's?

Mr. JACK S. LEVIN. I think the answer is that you see a fair number of transactions utilizing ESOP incentives, and that if you close down other uses of leverage, you will find that the ESOP transactions will probably then grow significantly.

One of the things we are saying is that you must be careful when you have a wall, that if you push part of the wall forward and leave a hole in the other part, you may find that what used to be a trickle becomes a flood through that hole. If you try to close down many forms of leverage but make no move toward reexamining, for instance, the ESOP use, you may find that that suddenly blooms into a very fertile ground.

At present it is a moderate ground. I am not in any way against ESOP's, Mr. Ford. Don't misread by testimony.

What I am saying is that if this committee wants to take legislative action against leverage now, ESOP reexamination is one of four or more fine-tuning adjustments that might be considered—as other forms of leverage are cut back, does there need to be some cutting back there?

We talked of zeros, we talked of maximum interest rates, we talked of ESOP's, and we talked of the investment in highly leveraged securities by foreign persons and tax exempts who are paying low or no tax.

All I am saying is ESOP's deserve to be considered as part of that broad spectrum because there are a large number of incentives toward leverage there. At present they are under control and doing just fine. But if changes in the law are to be made, this is part of the framework or fabric.

Mr. FORD. One final question before Mr. Dorgan.

Do you think it is healthy for the U.S. economy for so few people, I guess, to share in the capital ownership rather than a larger scope?

Right now you see specialists and managers who are the players and the participants. Oftentimes you see the employees who will have to work hard to repay this debt after the LBO's are in place.

Mr. JACK S. LEVIN. Several comments on that. The first is that when a company is sold in an LBO, frequently those reaping the profits, the premium prices, thankfully often include the employees through ESOP's, pension plans, or personal investments in the company.

In many buyouts I have seen, both public and private, it is employees who are making a large amount of money in selling the company. That is certainly a good thing.

Second, in many buyouts I have seen, you have employees participating in owning the stock of the purchasing company in order to give them more incentive.

Third, I might say that we are focusing here on a relatively narrow band of transactions. You are certainly focusing on the large public transactions that we read about in the paper. There are thousands and thousands out there of companies that are still owned by their original owners, have not gone through leveraged buyouts and where employees have substantial stock ownership. So I do not see a vast part of corporate America owned by a small group of people.

I see a series of highly publicized transactions that have maybe taken more significance than they warrant, that give the impression of concentration of ownership.

Mr. FORD. Yes, Mr. Yin?

Mr. YIN. Thank you, Mr. Chairman.

If I could just make a comment on what Mr. Levin has stated, I think that his metaphor about the wall, I agree with it wholeheartedly. His notion is that if you push in one part, a larger hole may develop in another part.

I like to think of it as the half-filled balloon where Congress is squeezing one part because it sees a problem and, obviously, another part pops out.

The problem that I see, whether involving ESOP's, some of these other suggestions made by Mr. Levin or by Professor Ginsburg, is that they are all just small pieces of the puzzle. One of the problems that we have seen over the last 8 to 10 years in tax legislation is that Congress is always behind the eight-ball.

Congress is reacting and doing a little squeeze job here, and a little squeeze job there. My hunch is if we keep on doing it and looking at it that way, we will be back again and again for more and more hearings on new tax problems.

There may be legislation that does something to one or more of the items that have been mentioned, but there will then be new ideas, new programs, new instruments created that will just create new tax issues.

It seems to me Congress really needs to look more at the fundamentals of the problem. Again in my stated testimony, I said conceptually it is really quite simple. If we are serious about collecting two tiers of tax, then let's look at those two tiers of tax.

Look at the corporate-level tax and determine whether we are recognizing the gain at the appropriate time. Look at the shareholder-level tax and determine whether we have a distribution out of corporate solution, and, if so, whether we are picking up what we are supposed to pick up, which is another level of tax at that time. If we look at those fundamentals, I think a lot of this will go away.

Mr. FORD. Mr. Dorgan.

Mr. **Dorgan**. Thank you, Mr. Chairman.

Mr. Levin, in your testimony you state you are not an economist. You lecture in law and you carefully state you are not an economist.

You discuss many of these transactions and mergers, and go on to talk about the creation of jobs. As a public policy maker would you believe that to be the case or would you believe alternative studies which make the case quite differently. They would make a case that those mergers cost jobs, a case that the target companies in hostile takeovers are not underperformers.

Do you have empirical data to share with this committee if what is going on is good for the company and promotes efficiency?

Mr. **Jack S. Levin**. Not being an economist I am not in a position to present here empirical data and statistics. I have read many studies. I also have focused in my remarks not purely on hostile takeovers, as you mentioned.

There is a whole range of mergers, acquisitions and takeovers out there of which only the very tip of the iceberg are hostile. They are the ones you read about in the Wall Street Journal.

They are the ones that get the most publicity, but they are the small minority of the transactions.

Mr. **Dorgan**. I keep using the minnow and the whale analogy. When you read about a whale, you can have thousands of minnows out there playing little games every day that don't have much of an effect on the economy.

What we have is a situation in this country where large corporate entities are put into play daily, weekly, in this hostile takeover game. In my judgment, it does have a significant impact on the country.

Mr. **Jack Levin**. The point I was making is there are millions of minnows out there, some of them not as small as you might think, and they are engaging in friendly buyouts, friendly mergers and acquisitions. The vast majority of those, as well I believe as the majority of the hostile transactions, have moved inefficient companies into the hands of more efficient managers, have reduced unnecessary corporate overhead, have allowed companies to be operated in a more entrepreneurial fashion, have indeed created many jobs, have allowed selling shareholders to realize enhanced values, and have given public shareholders, including pension funds who are investors in companies, the opportunity to realize control premiums.

Not every hostile transaction you read about takes place; only the small minority of those actually happen. But thousands and thousands of friendly transactions take place which enhance efficiency and help to make this country more efficient.

Undoubtedly there are transactions on both sides of the ledger. I am trying to tell you that what I see from being up close, both as a law teacher and as a practitioner, is that the vast majority of the transactions I have been associated with have resulted in what I believe to be good things for our economy.

Mr. **Dorgan**. I appreciate those comments.

The development and placement of junk bonds has represented the engine by which those who want to find undervalued assets are drawn.

My guess is if you were running a major corporation in America today, you would be forced to care a whole lot more about what happens to your corporation in the short run than what happens in the long run. You would worry about what you were doing to present to the financial community tomorrow and in the next quarter, rather than what you were doing to build your company's base and the foundation for the next year or the next 5 years for international competition.

I submit to you, that is not good for this country. We have a difference of opinion on some of these issues.

Mr. JACK LEVIN. Not on that one. We both agree that long-term values are more important than short-term values.

I believe in the vast majority of the transactions that I have been up close to, where leveraged buyouts took place, the buying group was intimately interested in the long-term values in order to make their profits. It is only a very small minority of transactions where people expect to realize a profit short-term—most have the idea of building a bigger, stronger company and not selling after 3 months. You see that talked about in the Wall Street Journal quite a bit.

The transactions I have been involved in, the vast majority have been people who bought with the idea of building a stronger, better, more efficient company, therefore realizing after some years the values they had built.

Mr. DORGAN. Well, I wish I could believe that is the rule. I happen to think that is the exception. My notion is that the people we read about today in corporate America are spending a lot of their time trying to figure out how they avoid the takeover folks who swagger around town with billionaire funds. I don't think their interest is in running a business they know very little about; I think their interest is in scavaging for undervalued assets, breaking them up and selling them for a profit.

The reason these hearings are important, is to compare various opinions and approaches on what we ought to be doing in this country. I think all of us understand that it would be foolish of us to act spontaneously. We need to act carefully.

All of us, I expect, share the same goal but probably differ in our approaches. The goal we share is to try and figure out how we pay attention to basics, how we convince corporate America to be prepared to compete internationally. That is the goal all of us share. We might have different approaches in dealing with that.

I thank you all for testifying and coming before the committee.

Mr. FORD. Mr. Guarini.

Mr. GUARINI. Thank you, Mr. Chairman.

In following the discussion, it seems to me that one of the driving forces of LBO's—and there are some good ones and some bad ones—is meeting the new interest charges, the junk bonds, and looking to find the wherewithal to fund the new enterprise.

For that sometimes they cut back in research and development. For that they spin off corporations they might be able to sell off, which may mean a lot of employment is lost.

It doesn't seem to me to be very healthy to have large interest payments on junk bonds being the engine for business decisions that have to be made.

The people who get involved in this takeover game often are the Icahns, who are good and probably very bright people, but they get into fields where they don't have the expertise. They go out and try to find the expertise, but they don't come in because they are corporate managers with the expertise of that particular kind of company. They come in often because there is a good deal there. They can move the numbers around to their satisfaction.

I am just wondering whether or not there are any suggestions that you make in the accounting end of it. Everybody talks about tax aspects. Do you have any recommendations to make in regard to giving better notice to stockholders or how to deal with the arbitrage; how to cap the floating interest rates; how to cut down huge fees the investment houses and banks are making, up to six points, where they give points and if the deal flies they get paid, and if it doesn't fly they don't get paid, which encourages them to make a deal.

It seems there are a lot of areas which are regulatory which we could give thought to, as to how to develop a better vehicle. We don't want to throw out LBO's or mergers and acquisitions. Of course, it makes our economy more competitive and makes us smarter.

I would like to hear what you suggest as to how to straighten up on our act. How can we better supervise and have better accounting procedures where the abuses will not happen, where we can separate the good guys from the bad guys?

Do you have any opinion on that? Mr. Yin?

Mr. YIN. I don't have any magical solution, as I am sure you are aware. I don't believe there is one.

The substance of what I have tried to say and I should also confess that I, too, am not an economist or a securities lawyer, for that matter, is the notion that there is a tax subsidy in many of these transactions.

Whether the subsidy in fact is separating the good guys from the bad guys, as you suggest, I don't know. But it seems to me it is proper for the committee to determine, "Do we want to subsidize the transactions at all?" If the committee determines that it doesn't want to, then I have made some suggestions on how to take away the subsidy.

Whether in fact this is distorting corporate behavior, I don't know.

Mr. GUARINI. Do you believe we have to have adequate regulation?

Mr. YIN. I guess the only question I have to say is I don't know how to define adequate regulation. We have some regulation now. The question would be, "Is what we have now adequate or not?" That is just beyond my area of experience.

Mr. GUARINI. Are there any economists on the panel? Are you all lawyers?

Mr. JACK LEVIN. I will make a comment.

My comment is that the hearings being held by this committee and the publicity that leveraged buyouts have received recently I think are beneficial. They are beneficial to call to the attention of financial institutions, regulators and the people involved in these sorts of transactions that prudence and caution are necessary. I believe that prudence and caution are necessary. But I believe that it is very difficult for this committee, either through the tax laws or through regulatory rules, to lay down guidelines which will separate the good guys from the bad guys. That is very difficult to do.

Mr. GUARINI. But do you have any suggestions?

Mr. JACK LEVIN. What I think is that the free market does a very good job when it has all the facts.

Mr. GUARINI. We have been in the free market, and the free market is why we are having these hearings, because there are abuses. We have been in the free market on S&L's. We have been deregulating many things, our railroads, investment houses. It seems as though if there aren't adequate supervision and accounting procedures, the free market with its greed—and we must admit that Wall Street has its share and its brand of greed—we become less strong as a nation, because instead of working out better productivity, instead of working out education and plant expansions, we work out a bunch of numbers where people with green shades over their eyes work late into the midnight oil finding out how we can manipulate numbers and make huge fortunes.

If that is the way America is going, I suggest the United States is going to be in tough shape. We are asking in these hearings, "Where are we going? Where are we going as a country economically? How can we be more productive?" You are telling me, from what I understand—and it is a lawyer's position; you are a professor of law—that everything is fine out there.

I would like to hear from some of the economists and the people who actually have experience, where we can correct some of the abuses so that we can indeed separate the wheat from the chaff, what is good for America and what is bad for America.

Mr. JACK LEVIN. I have on the last page of my testimony made several suggestions. One of those is to make clear, as the Department of Labor has in the last few days, that trustees are not required by their fiduciary duty to sell when a buyout proposal is made at a premium, but rather that the trustees are entitled to take into account their good-faith expectations as to the future share performance of the company if the buyout is rejected. The Department of Labor has done that this week. I think that is a good development.

A second suggestion that I made is to require institutional investors, such as banks, pension plans, university endowment funds, and the like, to disclose separately all risky investments, whether oil and gas, real estate in depressed areas, or LBO investments, so that the appropriate regulators and the people to whom the institution's management are responsible can judge management's performance and make sure management is not investing too much in risky assets.

Mr. GUARINI. How do we find risky businesses?

Mr. JACK LEVIN. I think that is why we have expert regulators, such as the Fed and the Comptroller and others. You mentioned the savings and loan situation. Now, I don't purport to be an expert in that, but I will tell you that from my study of the savings and loan situation, what strikes me is that for several years regulators were not prodded enough to take action as the savings and loan situation slid into crisis instead of taking action to stop the hemorrhaging. Artificial accounting policies were adopted that hid the problem. I do not believe there are any artificial accounting policies being utilized in the LBO field.

I happen also to be a CPA, although I am not practicing, and in my study of buyouts, I don't believe there are any artificial accounting policies adding to the use of leveraging buyouts.

Mr. GUARINI. Well, there are various opinions that have to be rendered to satisfy the SEC, and I understand that if the deal flies, you get paid, and if it doesn't, there is no money there, which really doesn't militate well for people giving objective opinions. They are going to go the course of their pocketbook, and this doesn't really help the accounting procedures within the SEC.

Mr. JACK LEVIN. Just so we are clear, that has nothing to do with accounting. The point you raise is certainly a valid and legitimate one, and one that has been subjected to substantial debate and one on which I think further examination may well be warranted. Contingent fees for fairness opinions certainly do sound like an area that should be studied further. It is not an accounting issue.

I was trying to respond to your point on accounting issues, but that too is one of the legislative areas that may be appropriate. I didn't come here prepared to give you details on those, but rather tax issues.

Mr. GUARINI. I understand that.

As far as banks are concerned, where they sell out the pension funds, I understand that often the work is done by the main bank that is putting together the package, and they might sell $100 million to 10 other investment houses and no one else does their homework. They just take the work and the facts and figures, analysis made by the principal bank, thinking that is all that has to be done, and they, instead of responding to the responsibilities of their duties as trustees of the pension fund, just say, "Fine, we will take 10 percent of that."

And I think that there is some criticism out there of people not putting together their own basic analysis, that they depend upon the thinking of other people. So that they then don't exercise the responsibilities of trust to their particular fund. Have you had any experience in that?

Mr. JACK LEVIN. In those transactions that I have been involved in, I have found that all the people that we were dealing with carefully did their homework, and frequently some would decline to invest in the credit because they didn't think it was adequate, others would invest in it.

I will agree with you, that there are times when you might have a consortium of 10 banks and the lead bank will do the principal homework, the other banks will review it. However, Congressman, usually the lead bank is selected as lead bank because it has exhibited a history of doing careful analysis and careful study, and if it falls down in that regard, the free market system will make sure from then on no one will use it as lead bank. And so they are very scrupulous in the transactions I have been involved in doing their duty, because they cherish their position as being a lead bank and do not want to lose that.

Mr. GUARINI. That was a point that was made by Nick Brady, the Secretary of Treasury. He thought that there was too much dependence on the original investment house and not enough of their own individual thinking, where they could pick up problems along the way.

Thank you, Mr. Chairman.

Mr. FORD. Mrs. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman.

I am sorry I haven't been able to hear all of your testimony, but in reviewing summaries of it and listening to the discussion, I would just like to ask you about some regulatory changes that have been suggested to us that would avoid the pitfalls of excessive legislating while at the same time create a structure within which we would be more likely to support the profitable LBO's and discourage some of the ones that we consider to be more speculative.

For example, it was proposed that government-insured deposits should not be allowed to be invested in junk bond transactions, and another important proposal was security firms should not be allowed to underwrite securities for firms in which they have a direct stake themselves, whether an equity stake or bridge loan.

A number of you have supported the proposal that there are ways in which we could improve the quality of our regulation to encourage prudence. Would these be measures you think would encourage prudence without creating rigidity? Would any of you care to comment?

Mr. JACK LEVIN. The way in which most leveraged buyouts are structured is there are layers of indebtedness with each layer getting successively more risky and hence bringing with it a higher interest rate to compensate the lender for the risk.

In general, government-insured deposits, meaning bank money, is at the top or safest level. Banks usually hold the senior secured debt. Down below that comes what we frequently refer to as the junk bonds, meaning subordinated debt, subordinated in the sense it is subordinated to the senior debt and will not take a penny of repayment unless the entire senior debt is repaid.

The subordinated debt, sometimes denominated junk bonds, generally carry much higher interest yields to compensate the holder for the extra risk. Those, to the best of my experience, are almost never held by banks that are government insured. My experience has been that the banks are in the senior debt.

And, therefore, when you raise an issue as to whether government-insured bank deposits should be invested in junk bonds, I have two reactions. First is that I think it doesn't sound like a very good idea for government-insured bank deposits to be invested in junk bonds, but, second, I want to make sure I don't by that answer give the impression I think that is happening now in any widespread fashion. I don't believe it is. I think that prudence has controlled there already.

Mrs. JOHNSON. Thank you. That wasn't the implication of earlier testimony. How about the issue of securities firms being allowed to underwrite securities for firms in which they have a direct stake themselves?

Mr. JACK LEVIN. I don't believe I would be the right one to comment on that.

Mrs. **Johnson**. Would any of you have a comment on that?

Mr. **Ginsburg**. No, but perhaps on behalf of my colleagues I can level with you. I cannot think of a good reason why this committee should listen to any of us on these subjects. It is not our area of expertise.

Mrs. **Johnson**. Thank you. Thank you, Mr. Chairman.

Mr. **Guarini** [presiding]. Thank you, gentlemen. We appreciate your comments and helpfulness and having the benefit of your opinions.

I would like to call the next panel: Rick Johnson, founder and managing partner of Johnson Partners, New York, NY; George Brode, Jr., George Brode, Jr., Ltd., Chicago, IL; and Leigh B. Trevor, partner, Jones, Day, Reavis & Pogue, Cleveland, OH.

Gentlemen, we will put your official remarks into the record, and you need only comment on the contents of your written remarks. We would first like to hear from Rick Johnson.

STATEMENT OF RICK JOHNSON, FOUNDER AND MANAGING PARTNER, JOHNSON PARTNERS, INC., NEW YORK, NY

Mr. **Johnson**. My name is Rick Johnson, founder and managing partner——

Mr. **Guarini**. Speak into the microphone.

Mr. **Johnson**. I am Rick Johnson, founder and managing partner of Johnson Partners in New York. I am an LBO practitioner.

In sharp contrast to the transactions that dominate the news, the kind of companies that we buy and transactions we look to arrange are friendly management buyouts of manufacturing companies, 20 to 200 million in size, typically in the Midwest, Southeast or Mid-Atlantic States. These are companies that are going to be sold, most often they are private or closely held or they may be divisions or subsidiaries of larger companies that have decided to sell them because they no longer meet their strategic needs.

These transactions are always friendly. Management always participates substantially. Employees often participate. They are financed for the most part with senior debt, subordinated debt provided from insurance companies when necessary, and equity.

It has been my experience that in all cases the operations of these companies have improved when the people responsible for their operations in fact become shareholders, and it is my fear that this kind of a transaction that doesn't appear on page 1 of the Wall Street Journal daily, that doesn't involve bankrupts, that regulation may adversely affect it.

And what we have found is that it offers a way for equity to be dispersed among managers and employees who heretofore didn't have a chance to own equity, that operations improve because the company operates more efficiently, and we think that from an economic standpoint, from a standpoint of social policy, it is good for the country.

Mr. **Guarini**. Thank you very much.

[The statement of Rick Johnson follows:]

TESTIMONY BEFORE THE COMMITTEE ON WAYS AND MEANS
OF THE U. S. HOUSE OF REPRESENTATIVES
FEBRUARY 2, 1989

Rick Johnson
Founder and Managing Partner
Johnson Partners Inc

Background

Since graduating from Harvard Law School and Harvard Business School in 1975, I have spent my entire professional career in various aspects of corporate and securities law, corporate finance, mergers and acquisitions and leveraged buyouts. I was a General Partner in a nationally recognized leveraged buyout firm specializing in transactions involving employee stock ownership plans (ESOPs) prior to forming Johnson Partners.

Johnson Partners arranges friendly, management buyouts of manufacturing companies from $20 million to $200 million, located in the Midwest, Southeast and Mid-Atlantic states. These companies are in basic industries, have profitable operating histories and in-place management. Most of our targeted acquisitions are private companies or divisions or subsidiaries of public companies. In the case of private or closely-held companies, the controlling shareholders have decided to sell for estate planning reasons, lack of family succession or simply liquidity. Public companies are continually divesting themselves of divisions and subsidiaries which no longer fit their corporate strategy. In both cases the decision has been made to sell, the only issue is to whom.

Our approach is very conservative. The transactions we pursue do not require asset or real estate sales, the closing of plants, layoffs or other "heroics" in order to succeed. Also, because of their size, they do not rely on junk bond financing, which can be problematic in uncertain markets. Management receives a substantial equity interest in the acquired company. Where appropriate (and without any diminution in defined benefits), we also provide for equity ownership by the employees through the use of ESOPs or profit sharing incentives.

Purpose

My purpose is to bring to the Committee's attention the kind of transactions I have just described. These transactions, also referred to as leveraged buyouts, do not dominate the news. They do not engender hostile bidding contests nor are they controversial. These transactions are economically sound, socially benign, and broaden rather than concentrate capital ownership. Managers are eager to invest personally in order to participate in the equity of the new company. Such transactions inevitably result in more efficient operations, and in my view, ultimately serve to make the United States more competitive. They provide liquidity to sellers and permit managers (and often employees) to share in economic growth and enjoy the rewards of equity ownership.

Conclusion

From an economic, policy and social perspective, it is not at all clear that leveraged buyouts are bad for the country or the economy. In fact, most evidence suggests the contrary. Notwithstanding the deductibility of interest on the acquisition debt, the Treasury, as a result of capital gains taxes, income taxes resulting from increased corporate profitably and taxes on interest income, is probably ahead. All studies and accounts that I am aware of show that companies operate more efficiently when management (and especially when the employees) become significant shareholders. The Secretary of the Treasury has stated that our national goal should be to encourage business to focus more on long-term growth and less on short term profits. The kind of leveraged buyout transactions I have described further, rather than retard or impede, this objective.

We would strongly urge Congress not to take any action which would adversely affect the host of small, private transactions which occur daily without debate, controversy, or notoriety. These transactions are generally financed primarily with senior bank debt. Subordinated debt is provided from insurance companies and other institutional lenders. Because of their size these transactions generally do not involve junk bond financing. These transactions, especially when the employees participate, serve to broaden equity ownership, retain and expand job opportunities in the local community, and provide the seller with a viable alternative to selling to a larger company or foreign interests. Such transactions encourage entrepreneurship and reward managers and employees for their efforts.

Congress should allow the free market to correct any perceived "excesses." Relative to the risk each incurs, senior debt holders, subordinated debt holders and equity holders have different interests, different claims and priorities and therefore different rate of return expectations. To the extent there are "excesses" - too much risk and too little return- natural market forces will serve to eliminate them. In large, highly visible, auctioned transactions, for instance, the market has become more efficient and rates of return for equity investors are declining.

Congressional Objectives and Concerns

The overriding objective, from a national perspective, is to encourage productive investments in American industry which further the long-term competitiveness for American goods and services in the world markets. The Speaker of the House was recently quoted as saying the intensification and concentration of economic wealth into the hands of fewer and fewer have begun to erode the broad base of the American economy. Some mergers, acquisitions and leveraged buyouts, it has been suggested, do not further this national objective because they variously result in unacceptably high levels of debt (leverage), divert needed capital from research and development and capital expenditures, result in layoffs and plant closings, and cause the breakup of healthy companies which contribute jobs to their local communities. Some critics have also charged that because of the deductibility of interest on acquisition debt, these transactions are unfairly subsidized by the tax-paying public.

To further this national objective and to curb the perceived "excesses," Congress is considering, among other things, reducing the interest deduction for certain kinds of transactions or so-called junk bonds, thereby making such debt financed transactions less attractive, permitting the deduction of corporate dividend payments, thereby eliminating double taxation, and reducing the capital gains tax, thereby encouraging long-term investment.

History and Evolution of Leveraged Buyouts

The term "leveraged buyout" has been part of our financial vocabulary for about a little more than a decade. It has been used to describe a transaction in which management and an outside group, typically a leveraged buyout firm, buy a company from its private owners or public shareholders. Equity for such transactions, generally ranging from 10% to 20% of the transaction value, is supplied by institutional investors such as public and private pension funds, university endowments and insurance companies. The debt, supplied by banks and insurance companies and the public through junk bond offerings, is then retired from the earnings of the company and a sale of its assets, if necessary.

While the term "leveraged buyout" became popular in the last decade, this type of transaction has been around for many years. The advantages of debt financing have long been known. Where potential buyers have had little equity of their own, they put together so-called "bootstrap" transactions like today's leveraged buyouts. Indeed, one can liken a leveraged buyout to the purchase of a home with 10% down in equity and a 90% mortgage The mortgage is amortized from the buyer's earnings ("cashflow") and the buyer's expectation is to sell at a profit once the debt is retired and the equity has appreciated. Like the home purchaser, most owners of businesses would not have had the opportunity to get started without debt financing- leverage.

It is useful to understand "leveraged buyout" transactions in their historical context in order to distinguish current public perception and the kinds of transactions which have given rise to the present Congressional concern. Presently, in the public mind and perhaps that of Congress, "leveraged buyout" suggests a transaction in which the buyer believes that the pieces of the company are, in aggregate, worth more than the whole company, as reflected in the price of its publicly traded stock. Typically, this kind of transaction is very large and is financed with bridge loans which are then converted to long-term debt through junk bond offerings. Because of the size of these transactions, the high premiums paid, and the cost of the financing, the acquired company's cashflow is insufficient to retire the debt. Therefore, in order to retire the acquisition debt, the buyer must sell various parts of the company. If the assets, divisions or subsidiaries of the acquired company cannot be sold at their estimated values, or if the junk bond financing cannot be sold (or can be sold only at prohibitively high interest rates), the success of the transaction is in question.

Large buyouts which must depend upon a break-up strategy comprise, in fact, only one segment of the leveraged buyout market. Smaller transactions are not structured to rely a on a break-up value strategy or junk bond financing.

Leveraged Buyouts- Facts and Fiction

When one examines the large number of leveraged buyout transactions which have been completed to date, one is struck by how successful these transactions have been from all perspectives. Companies bought by their managements and outside owners become more efficient. Profit margins improve; overhead is reduced. There is a new work ethic, competitiveness and sense of entrepreneurship. Particularly where employees are included in the transactions, there is a decided improvement in productivity and labor-management relationships. Rather than "we-they," zero sum adversarial relationships that characterize so much of American industry, there is a spirit of cooperation and common problem solving. There are no massive layoffs, and, in fact, employment levels may increase as the company's operations improve and grow.

In our experience, two factors primarily account for the success of leveraged buyouts. The most compelling is the effect of equity ownership by management and employees. The genius of capitalism is that people are motivated to work harder and more efficiently when they can benefit directly from their efforts. Where managers and employees do not have a substantial equity interest in the company for which they work, they simply are not motivated to behave like shareholders. They are not shareholders. This is particularly true in large public companies (and especially in conglomerates) where management and employees own very little equity. The shareholders' ownership is separated from control which is in the hands of the management. The interest of the shareholder is to maximize the value of the enterprise in order to produce the highest possible return on equity.

In large public corporations, the interest of management, on the other hand, is generally not to maximize value in the long term. Earnings per share are measured quarterly, and the stock market rewards decisions which may have a -positive, short-term effect on earnings, but which may not be in the long-run best interest of the company. On a more personal level, managers are rewarded as their span of responsibility increases (in terms of people, profits or revenues), generally not for enhancing long-term value. Also, because managers do not own a substantial equity stake in most large enterprises, they are driven, at least in part, by the perquisites of corporate station. In short, in large public corporations, or in divisions or subsidiaries of such corporations, management decision making is often much more bureaucratic than entrepreneurial. It is not necessarily in management's personal interest to maximize the value of the firm. Similarly, many private and closely held corporations are often not run to maximize operating profit (which is taxable) or cashflow. Rather, they are run to maximize the owner's comfort and lifestyle.

In sharp contrast, a well-structured leveraged buyout provides management with a substantial equity interest in the new organization. Managers assume significant, personal financial risk in acquiring that equity interest, and like other equity participants, they stand to gain or lose as that equity interest increases or decreases in value. In this economic environment managers make decisions which add to the long-term value of the enterprise because they stand the most to gain when the value of the enterprise increases. Managers act in the shareholders' interest because they are significant shareholders, themselves.

The positive impact of equity ownership is multiplied when it is extended beyond managers to all employees. Employees, too, then think of themselves as owners and act in ways to enhance the value of their own equity ownership. Returning to the analogy of the house, one has only to ask: Is there a greater incentive to take care of a house which one owns or which one rents?

The second factor which accounts for the success of leveraged buyouts is what has been described as the discipline of leverage. Just as the new house owner is very reluctant to miss a mortgage payment, lest he lose probably the most important investment he has ever made, so are the owners of a newly-purchased company highly motivated to discharge their debt obligations. Paying down acquisition debt by maximizing cashflow becomes the overriding business objective in the years immediately after the buyout. Like the mortgage on the house, the value of the equity ownership increases as the debt is retired.

Leverage- Checks and Balances

There is much concern about the effect of leverage and the general level of corporate debt, especially that incurred in acquisitions. It is often said that capital expenditures and research and development are drastically reduced because cash is needed to repay debt. In our experience, both discretionary and non-discretionary capital expenditures are always included in the projections lending institutions rely on in determining whether to finance the acquisition. Banks and insurance companies which provide the senior and subordinated debt simply do not lend money to a business which cannot afford needed capital expenditures.

With respect to expenditures for research and development, those companies which have major research and development needs are usually not good leveraged buyout candidates. Market forces prevent them from being financed. Very few transactions have been completed which have relied on the ability of the acquired company to produce new products as a result of future research and development efforts. The most successful candidates for leveraged buyout financing are companies with proven products in proven markets. Banks want to see acquisition candidates with demonstrated, consistent, predictable sales and cashflow, and with little, if any, new product development costs.

With respect to debt generally, Congress is contemplating regulation because it believes that the free market system of allocating capital resources is not working or is allowing debt to increase to imprudent levels (as deemed by Congress). We do not believe this contention is borne out by experience.

The disparate interests of the various sources of capital provide a natural (and workable) set of checks and balances. Strikingly few leveraged buyout transactions have failed. Senior lenders are secured by the assets of the company, rely on its cash flow or look for readily saleable assets, divisions or subsidiaries. For taking this risk, senior lenders are able to charge from 1 1/2% to 2% (and sometimes more) than the prime rate. Lenders willing to subordinate their claims to the senior lenders and sometimes forgo current interest payments, receive even higher interest rates. Depending on market conditions and the nature of the transaction, such subordinated lenders may also receive equity in the transactions as well.

Each party to the transaction does its independent analysis and independently determines to go forward. The assumptions and projections provided by management are "stressed" under various economic scenarios to determine under what circumstances the transaction fails, or exceeds acceptable risk tolerances. Lenders carefully consider the company's ability to support the debt in various economic scenarios. Only after each party has thoroughly analyzed the transaction and positively concluded that it is within the bounds of acceptable risk can a transaction be completed. This system, unaided by external regulation, has worked remarkably well. A natural set of economic checks and balances control the levels of debt permitted in a transaction.

Recommendation

In closing, we would ask Congress to consider how well the market place has handled the allocation of capital resources, and accordingly, whether it is appropriate or wise for Congress to attempt to fix something that is not broken. To improve the workings of the capital markets and to encourage long-term economic growth, we would suggest that Congress consider removing the "penalty" on equity investing by eliminating the double taxation of corporate dividends. We also believe that it would encourage long-term investing by reducing the capital gains rate- perhaps on a sliding scale over a five year period.

Mr. GUARINI. Mr. Brode.

STATEMENT OF GEORGE BRODE, JR., GEORGE BRODE, JR., LTD., CHICAGO, IL

Mr. BRODE. My name is George Brode, Jr. I am engaged in the practice of tax law as a sole tax practitioner in Chicago, IL. I specialize in Federal income tax matters relating to corporate acquisitions and closely held corporations and their shareholders. I have recently written a book entitled Tax Planning For Corporate Acquisitions, published by Prentice Hall/Rosenfeld Launer Publications in October 1988. I would like to emphasize that I am expressing my own views, and not those of any client or bar association.

In my opinion, if Congress chose to eliminate merely the interest deduction for LBO's, it would be addressing a symptom and not the disease. I believe that the much deeper problem is disincorporation arising from the radical disparity between corporate and individual tax rates.

One reason to disincorporate is to eliminate the double tax on the income of corporations—once at 34 percent when the corporation receives such income and pays tax, and a second time at 18.48 percent when the after-tax balance is distributed to shareholders. In a partnership or S corporation, the income is taxed only once, generally at 28 percent. In essence, use of a corporation will result in a double tax of 52.48 percent, while use of a partnership, S corporation or sole proprietorship will generally result in a single tax of only 28 percent. This difference of 24.48 percent represents a reduction of 46.65 percent.

A second reason to disincorporate is to avoid the double tax conclusion now required in connection with a taxable acquisition. Under prior law, no tax was imposed at the corporate level in a taxable acquisition except for recapture items. Rather, a single tax of 20 percent was imposed solely at the shareholder level.

This one tax conclusion was radically changed by repeal of the *General Utilities* doctrine in the Tax Reform Act of 1986. Under current law, a double tax now applies to any gain realized in a taxable acquisition. I have attached to my testimony a simple example which explains the dramatic impact this change has on the four standard acquisition techniques.

That example demonstrates that in a taxable stock purchase followed by a section 338 election, the overall effective rate of tax for both parties is 62 percent under current law versus only 20 percent under prior law. That represents an increase of 210 percent in the effective rate of tax on the same transaction.

In a taxable asset acquisition, the overall effective rate of tax is 52.48 percent under current law versus only 20 percent under prior law. This represents an increase of 162.4 percent in the effective rate of tax on the same transaction.

Before the Tax Reform Act of 1986, after-tax earnings were retained in the corporation rather than paid out as taxable dividends. Retained earnings created pools of capital that were used to increase employment, to modernize the plant, and to buy new equipment. Use of a corporation under prior law was similar to a pension plan because it deferred the receipt of ordinary income and had the added benefit of converting that ordinary income into capital gain. This technique actually promoted savings and reinvestment for corporations—just as ERISA has been used to promote savings and investment for individuals.

However, after the Tax Reform Act of 1986, it no longer makes sense to leave the money in the corporation. Under present law, when you go to sell off the business, those plowed-back earnings and profits are now subjected to double tax because of the repeal of the *General Utilities* doctrine. People now ask: "If there is no tax advantage to keeping my assets in corporate form, why shouldn't I bail them out?" The answer is simple. They should, and they are. And they will continue to do so more and more until Congress addresses that disparity in rates.

Because of these factors, after the Tax Reform Act of 1986, corporations began to disincorporate by either liquidating or becoming a partnership or S corporation. To prevent publicly traded corporations from becoming master limited partnerships, Congress closed off that escape route by treating such entities as corporations in the Revenue Act of 1987.

In that regard, an LBO is analogous to a liquidation in that the purchaser buys up the stock using borrowed funds, auctions off the assets to the highest bidder, pays off the indebtedness, and then closes down the corporation once the assets are sold off. So viewed, LBO's are simply an efficient disincorporation vehicle used to convert corporate assets taxable at 52.48 percent into cash taxable at 28 percent at the shareholder level.

Looking ahead, unless this rate disparity is abated, it may trigger the disincorporation of corporate America in a forced liquidation sale in order to take advantage of the 46.65 percent reduced rate of tax. Assets will continue to flow to the most efficient user of those assets.

Disincorporation will moderate only if Congress takes steps to restore a greater equilibrium between ownership of assets held by corporations versus individuals. To do this we need to provide tax incentives for people to leave their cash invested in corporate equities. The present law discourages such actions.

This could be accomplished by addressing the fundamental problem of the corporate double tax that now applies both to income and to gain from taxable acquisitions. Specifically, I recommended, first, adoption of a dividend paid deduction to address the income portion of that rate imbalance.

Second, I believe you should restore the prior nonrecognition of gain provision for corporations in connection with a taxable acquisition of a corporate business to address the rate imbalance caused by gain on taxable acquisitions.

That concludes my prepared remarks. Thank you for inviting me and affording me the opportunity to express my views.

Mr. GUARINI. Thank you, Mr. Brode.

[The statement of George Brode, Jr., follows:]

STATEMENT OF GEORGE BRODE, JR. HEARINGS ON THE TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS BEFORE THE COMMITTEE ON WAYS AND MEANS HELD ON FEBRUARY 2, 1989

My name is George Brode, Jr. I am a sole tax practitioner specializing in Federal income tax matters relating to corporate acquisitions and closely held corporations and their shareholders in Chicago, Illinois. I have recently acted as Special Tax Counsel to the Illinois State Bar Association and the Chicago Bar Association, past Chairman of the Federal Taxation Section of the Illinois State Bar Association, past Chairman of the Subcommittee on Redemptions, Committee on Closely Held Corporations, American Bar Association Section of Taxation, General Editor of a two volume book entitled Closely Held Corporations published by the Illinois Institute for Continuing Legal Education, author of more than 80 articles on federal income tax matters, and, most recently, author of a book entitled Tax Planning For Corporate Acquisitions, published by Prentice Hall/Rosenfeld Launer Publications in October, 1988. The following comments reflect my own personal opinions and should not be construed as representing the opinion of any bar association.

POSITION

I believe that if Congress chose to eliminate merely the interest deduction for LBOs, it would be addressing a symptom and not the disease. The much deeper problem is disincorporation arising from the radical disparity between corporate and individual tax rates. LBOs are simply an efficient disincorporation vehicle used to convert corporate assets taxable at 52.48%[1] into cash taxable at 28%.[2] Disincorporation will moderate only if Congress takes steps to restore a greater tax equilibrium between ownership of assets held by corporations versus individuals. This could be accomplished by addressing the fundamental problem of the corporate double tax that now applies both to income and to gain from taxable acquisitions. Specifically, I recommend (1) adoption of a dividend paid deduction to address the income portion of that rate imbalance, (2) restoring the prior nonrecognition of gain provision to corporations in connection with a taxable acquisition of a corporate business to address the rate imbalance caused by gain on taxable acquisitions, and (3) other ancillary actions to solve the debt/equity problem.

THE PROBLEM

We are in the midst of a period which later historians could well term the "selling of corporate America." I believe that recent LBO acquisitions have unintentionally been aided by passage of the Tax Reform Act of 1986. LBOs occur, at least in part, by reason of the significant 24.48% disparity between corporate and individual tax rates, i.e., the double tax rate for corporations of 52.48% both on income and in connection with gain from a taxable acquisition of a corporate business, versus the single tax rate for individuals of 28%. This differential represents a reduction of 46.65% in the effective rate of tax on

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[1] Corporations are subject to a double tax on income - - once at 34% when the corporation receives such income and pays tax, and a second time at 18.48% (i.e., 66% times 28%) when the balance is distributed to shareholders.

[2]

Year	Total Mergers and Acquisitions		Leveraged Buyouts				LBO value completed/announced as percentage of all merger value
	Number of transactions completed	Total dollar value (billions)	Number of transactions completed	Total dollar value (billions)	Number of transactions announced	Total dollar value (billions)	
1986	2,875	246.87	125	42.10	162	45.70	17%/19%
1987	3,568	219.54	124	36.87	177	52.76	17%/24%
1988	3,367	287.98	129	39.42	211	131.87	14%/46%

Source: IDD Information Services, New York, N.Y. 1988 LBOs announced includes RJR Nabisco's $24.53 billion December 1988 transaction which will close in February 1989.

the exact same income. This disparity in rates, in turn, is causing a disincorporation of corporate America, simply because it is more economical for shareholders to hold the capital assets taxable at 28% than it is for the corporations to hold those same assets taxable at 52.48%. LBOs are merely a very efficient way to get that cash out to the shareholders.

A second factor is the repeal of the General Utilities doctrine in the Tax Reform Act of 1986.[3] It is important to realize that under prior law, the normal double tax conclusion did not apply in connection with distribution of assets by a corporation in a taxable acquisition of a corporate business. In essence, only one tax was imposed on that transaction, and that tax was collected at the shareholder level under a theory known as the General Utilities doctrine. I have attached to my testimony a simple example which explains the dramatic impact repeal of General Utilities has on the four standard taxable acquisition techniques both before and after the Tax Reform Act of 1986. By eliminating the extraneous shareholder basis or recapture issues, and insuring that the results are directly translatable into a percentile, the "pure" impact of the repeal of General Utilities may easily be observed.

That example demonstrates the following:

First, in a taxable stock purchase followed by a sec. 338 election, the effective rate of tax under current law would generally be 62%. Under prior law, assuming there were no recapture items, the same transaction would have been taxed at only 20%. This increase from 20% to 62% represents an increase of 210% in the effective rate of tax on the same transaction.

Secondly, in a taxable asset acquisition followed by a liquidation of target, the effective rate of tax under current law would generally be 52.48%. Under prior law, assuming there were no ordinary income recapture items, the same transaction would have been taxed at only 20%. This increase from 20% to 52.48% represents an increase of 162.4% in the effective rate of tax on the same transaction.

Before the Tax Reform Act of 1986, after-tax earnings were retained in the corporation rather than paid out as taxable dividends. Retained earnings created pools of capital that were used to increase employment, to modernize the plant, and to buy new equipment. With individual rates higher than corporate rates, the tax-laws were saying to shareholders: "Keep your profits in the corporation for expansion and for research and development. Leaving these funds in the corporation is a form of forced savings or reinvestment plan which will help the business grow and thereby increase its value. And, later down the road, if the business is sold, you'll only have to pay one tax, a capital gains tax of 20%, at the shareholder level." So viewed, use of a corporation under prior law was similar to a pension plan because it deferred the receipt of ordinary income and had the added benefit of converting that ordinary income into capital gain. This technique actually promoted savings and reinvestment for corporations - - - just as ERISA has been used to promote savings and investment for individuals.

However, after the Tax Reform Act of 1986, it no longer makes sense to leave the money in the corporation. Under present law, when you go to sell off the business, those plowed back earnings and profits are now subjected to double tax because of the repeal of the General Utilities doctrine. Moreover, individual rates fell from 50% to 28%. People now ask: "If there is no tax advantage to keeping my assets in corporate form, why shouldn't I bail them out?" The answer is simple. They should, and, they are. And they will continue to do so more and more until Congress addresses that disparity in rates.

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[3] General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). The General Utilities rule, which provided for nonrecognition of gain or loss in connection with a sale or liquidation of a corporation, was incorporated in prior law sec. 337. Congress believed that sec. 337 was responsible, at least in part, for the dramatic increase in mergers and acquisitions in recent years by artificially encouraging such transactions. Pub. L. No. 99-514, H.R. Rep. No. 126, 99th Cong., 1st Sess. 281 (1985). Subsequent events have not borne that out. Since passage of the Tax Reform Act of 1986, the dollar value of merger and acquisition activity has increased by 16.65%. In addition, the dollar value of announced LBOs has increased by 188.56%. See footnote 2, supra.

In short, when Congress changed the rules by requiring corporations to pay a tax of 34% on gain incurred in taxable acquisitions versus the prior law nonrecognition of gain rule of sec. 337 (except for recapture items), it accelerated the movement in this country to transfer assets away from corporations taxed at a high rate, toward individuals, taxed at a fraction of that rate.

In light of these factors, it was apparent under the Tax Reform Act of 1986, that regular corporations would seriously consider disincorporating, either by becoming a limited partnership or, in the case of publicly traded corporations, becoming a master limited partnership because MLP interests could be traded on a national exchange. Later, the Revenue Act of 1987, added new sec. 7704 which sought to prevent further disincorporation by treating publicly traded partnerships as corporations.

An LBO is a transaction that utilizes debt to generate tax deductible interest, which debt is used to buy up the stock, auction off the assets, and thus provide an extremely efficient mechanism to assist shareholders in removing their previously locked in capital from the corporation. So viewed, LBOs appear to be nothing more than another form of disincorporation. However, unlike the easy solution for publicly traded partnerships that are now treated as corporations, no quick fix is available to stop LBO disincorporations because individuals are not publicly traded entities and do not take on corporate characteristics.

Looking ahead, unless this rate disparity is abated, it may trigger the disincorporation of corporate America in a forced liquidation sale in order to take advantage of the 46.65% reduced rate of tax.[4] Assets will continue to flow to the most efficient user of those assets. It is an interesting form of poetic justice, that the really large corporations in this country are now starting to worry because they realize that their enormous size can no longer protect them against the present "auctioneers disincorporation mentality" to sell off assets.

By constantly tinkering with the tax laws, sometimes we make mistakes. I believe that under the prior tax law, we had reached a point of rough equilibrium. However, when the Tax Reform Act of 1986 radically reduced individual tax rates down to 28% (which I favored), and combined that with a significant increase in corporate tax from zero to 34% by repealing the nonrecognition of gain rule for taxable acquisition of corporate businesses (which I opposed), these two changes constituted a "double whammy" which, in my opinion, has served to fuel the flames of LBO acquisitions. Americans, as always, are simply responding in a rationale fashion to take advantage of the tax laws.

THE SOLUTION

We need to provide tax incentives for people to leave their cash invested in corporate equities. The present tax law discourages such actions. Since the problem arises, at least in part, because of the radical difference in tax rates, it makes tax sense to adjust that rate imbalance. First, as to the ordinary income portion of that rate imbalance, I recommend adoption of a dividends paid deduction similar to that discussed in the House version of the Tax Reform Act of 1986, but using a much higher rate than the proposed 10% deduction and also eliminating the ten year phase-in period.

Secondly, as to the gain from the taxable acquisition portion of that rate disparity which arose because repeal of the General Utilities doctrine reimposed a double tax in connection with a taxable acquisition of a corporate business[5], the simplest solution is to undo that aspect of the Tax Reform Act of 1986. By restoring the nonrecognition feature of prior law sec. 337 to acquisitions, there would be little or no tax at the corporate level in connection with sale of that business, and therefore greater incentive to consider reinvestment of profits in order to secure growth in corporate value on a tax deferred basis. This approach is far less radical than would be required if full scale tax integration of corporations and individuals were adopted.

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[4] That is, a reduction from 52.48% to a 28% rate of tax.

[5] By imposing tax on heretofore nonrecognized gain at the corporate level, the tax rate went from zero to 34% followed by a tax at the shareholder level of 28% or 18.48%, resulting in an overall rate of tax of 62% or 52.48%, which effectively increased the tax from pre-TRA '86 law by 210% in the case of stock purchases followed by a sec. 338 election and by 162.4% in the case of asset acquisitions. See example in Appendix attached.

These two basic steps would start to rectify the disequilibrium between corporate and individual rates both on ordinary income and in connection with corporate acquisitions, to shift the balance from debt toward equity, and to provide a significant inducement for leaving capital in corporate solution.

In closing, in order to promote savings/reinvestment in corporations so as to pay for future growth of corporate America, both large and small, you should partially address the enormous rate imbalance by (1) adoption of a dividends paid deduction and (2) restoration of the prior law sec. 337 nonrecognition of gain provision in connection with a taxable acquisition of a corporate business.

In addition to resolving the principal problem of the rate disparity, I believe that four ancillary actions could either separately, or in conjunction with one another, assist to solve the debt/equity problem:[6]

First, dry up the principal source of funds used to buy the junk bonds, namely, tax exempt pension funds by amending sec. 512 to treat interest earned on such bonds as unrelated business taxable income. This would prevent the double dip, i.e., a deduction to the purchaser for interest, followed by exclusion of the interest income from the bondholder by reason of its tax exempt status.

Second, impose a direct tax on LBOs and other acquisitions heavily financed with debt;

Third, consider elimination of the interest deduction for indebtedness incurred to fund a LBO provided such action does not give foreign buyers an unfair advantage to buy corporate America using their foreign interest deduction tax subsidy; or

Fourth, consider integration of corporate and individual taxation.

The overall net revenue effect of these proposals would, of course, have to be estimated in order to determine their feasibility.

That concludes my prepared remarks. Thank you for inviting me and affording me the opportunity to express my views.

APPENDIX TO TESTIMONY OF GEORGE BRODE, JR.

Example of Impact of Repeal of General Utilities On Acquisitions

In a taxable stock purchase followed by a sec. 338 election, in order to secure a step-up in basis, the buyer will have to pay a higher tax (imposed at the target's level) because the underlying nonrecognition of gain provision of prior law sec. 337, which was incorporated by reference in a sec. 338 election, was eliminated by the repeal of *General Utilities*. Thus, gain on a "deemed sale" of assets will be recognized by the target corporation. Second, due to repeal by TRA '86 of the corporate capital gains tax, all gain will be taxed at 34% in lieu of the former 28% corporate capital gain rate. Therefore, a "deemed sale" of the assets now results in a double blow - - not only is tax imposed at the corporate level on the prior law sec. 337 nonrecognition gain but tax on that gain will be imposed at 34% rather than at 28%.

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[6] In addition, Congress could consider non-tax solutions such a revision to federal anti-trust laws or the federal securities laws coupled with encouragement of state takeover statutes. Lastly, Congress could do nothing and allow the marketplace to correct the problem through either (i) a gradual increase in the value of publicly traded stocks until they reach a corporation's underlying asset break-up value, or (ii) collapse of enough LBO deals because the purchasers are not able to service the debt due to a miscalculation or a general economic recession.

In a taxable asset acquisition followed by a liquidation of the target corporation within 12 months under former sec. 337, effective January 1, 1987, the prior nonrecognition of gain treatment at the corporate level was eliminated, and the seller will pay tax on all gain experienced at the corporate level (not just recapture gain). To the extent this gain consists of long-term capital gain, it will be taxed at 34% in 1987 and thereafter. To the extent the gain consists of ordinary gain or loss, short-term capital gain, or gain from an installment sale under sec. 453B, the gain will be taxed at 40% in 1987 and at 34% in 1988 and thereafter. A second tax is paid at the shareholder level, when the after-tax proceeds are distributed, at a maximum rate of 28%. (A small portion may be taxed at 33% due to the 15% bracket phase-out hump.) Small "qualified corporations" are permitted to liquidate before January 1, 1989, under TRA '86 sec. 633(d) to avoid the impact of repeal of General Utilities, but no relief is provided beyond that date.

With the elimination of the corporate capital gain tax and the repeal of the investment credit, it follows that depreciation and investment credit recapture will also be eliminated. Unfortunately, the trade-off is that all gain will be taxed as ordinary income in 1988 and thereafter. Thus, in asset deals the overall tax is 52.48%, that is, 34% at the corporate level plus 18.48% on the balance taxed at the shareholder level (i.e., 66% times 28%). If a sec. 338 election is made, the overall tax may be 62% (or as low as 34% if a consolidated group sec. 338(h)(10) election is made). Under prior law, assuming there were no recapture items, the same transaction would have been taxed at no more than 20%.

Comparison: Purchase of Stock or Assets Before and After TRA '86

In a taxable transaction under prior law, there were four standard options:

1. Purchase of stock followed by a sec. 338 election by the purchaser.

2. Purchase of stock and no sec. 338 election by the purchaser.

3. Purchase of assets followed by a sec. 337 liquidation by the target corporation.

4. Purchase of assets, no sec. 337 liquidation, target remained in existence and may have operated as a personal holding company.

Option (1): Purchase of Stock/Sec. 338 Election

Assume that the target corporation's stock is acquired in 1988 for $20 million and that the target has an adjusted basis in its assets of $10 million. The target's shareholders have a basis in their stock of $10 million. Assume further that the target has no assets that generate ordinary income recapture, and the purchaser makes a sec. 338 election to step up the basis in the assets from $10 million to $20 million. By eliminating the extraneous shareholder basis issue and recapture issue, one can easily examine as a percentile the "pure" impact the repeal of General Utilities will have on the standard transactions under the new law versus prior law.

The gain under TRA '86 will be taxed as follows: Gain of $10 million (i.e., $20 million less $10 million adjusted basis) is taxed to the target corporation at 34%, resulting in tax of $3.4 million. Under prior law, any depreciation, investment credit, or LIFO inventory recapture gain (as well as tax benefit theory ordinary gain items) was subject to tax at 46%. The remaining gain escaped tax because such gain was not recognized at the corporate level under prior sec. 337.

Under these facts, the difference in tax to the buyer is $3.4 million, i.e., the tax is $3.4 million under the new law while the tax would have been zero under prior law.

The tax to the target's shareholders on a gain of $10 million (i.e., $20 million less their adjusted basis of $10 million) is $2.8 million (28% of $10 million). Under prior law, the tax would have been $2 million (i.e., 20% of $10 million).
Total tax to both parties would be:

New law:		
Corporate level	$3,400,000	
Shareholder level	2,800,000	
Total taxes		$6,200,000
Prior law:		
Corporate level	-0-	
Shareholder level	$2,000,000	
Total taxes		2,000,000
Difference		$4,200,000

In essence, in a stock sale/sec. 338 election, the effective rate of tax under the new law would be 62% under these facts.[7] If a consolidated group sec. 338(h)(10) election is made, the tax may be as low as 34%.[8] Under prior law, assuming there were no recapture items, the same transaction would have been taxed at 20%. An increase from 20% to 62% represents an increase of 210% in the effective rate of tax on the same transaction.

Option (2): Purchase of Stock/No Sec. 338 Election

Assume the same facts as in Option (1), except that the purchaser does not make a sec. 338 election to step-up its basis in the target's assets.

Because the purchaser has not elected under sec. 338 to step up its basis in the target's assets, the purchaser secures a carryover basis of $10 million (i.e., the target's then adjusted basis) rather than its $20 million purchase price with certain adjustments. While no tax is imposed on the purchaser in this transaction, the purchaser has, in effect, paid $20 million for an asset on which it may only recoup $10 million via depreciation deductions, i.e., it has lost $10 million in taxable basis.

The target's shareholders will recognize a gain of $10 million (i.e., $20 million less their $10 million adjusted basis) on which tax of $2.8 million (28%) is imposed. Under prior law the tax would have been $2 million (i.e., 20% of $10 million).

The total tax to both parties would be as follows:

New law:		
Corporate level	-0-	
Shareholder level	$2,800,000	
Total taxes		$2,800,000
Prior law:		
Corporate level	-0-	
Shareholder level	$2,000,000	
Total taxes		2,000,000
Difference		$800,000
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[7] If a purchaser seeks out target companies that have a high basis in their assets, i.e., nearly equal to the purchase price to be paid for the stock (and thereby the value of the assets), the 34% corporate level tax could be avoided. This would reduce the overall effective rate of tax to 28%.

[8] If the target corporation was a member of a selling consolidated group within the meaning of sec. 338(h)(10)(B), and the selling consolidated group and the purchaser make an election under sec. 338(h)(10), overall tax on this transaction under the new law should be 34%. The Conference Report noted that it continues to provide taxpayers relief from "potential multiple taxation at the corporate level of the same economic gain, which may result when a transfer of appreciated corporate stock is taxed without providing a corresponding step-up in basis of the assets of the corporation." H.R. Rep't No. 841, 99th Cong., 2d Sess. II-204 (1986). See generally Bush and Mullaney, "Section 338(h)(10) Under The New Temporary Regs," 65 J. Tax'n 130 (1986). For state and local tax consequences, see Brode, Tax Planning For Corporate Acquisitions, Chapter 12 (Prentice Hall/Rosenfeld Launer Publications 1988).

The $800,000 represents, in effect, the 8% difference between capital gain rates at 20% and 28%. This approach should be favored after TRA '86 especially if purchaser can locate a seller that has a high basis in its assets, i.e., nearly equal to the purchase price paid for the stock. Under that scenario, the purchaser could avoid any corporate level tax, secure a high basis in the assets, and avoid the lost depreciable basis problem noted in the example.

Option (3): Asset Acquisition Followed by Complete Liquidation Under Sec. 337

Assume that the target corporation's assets are acquired in 1988 for $20 million and that it has a basis in those assets of $10 million. The shareholders have a basis in their stock of $10 million. The target has no assets that generate ordinary income recapture.

The gain under TRA '86 would be taxed as follows: Gain of $10 million (i.e., $20 million less the target's $10 million adjusted basis) is taxed to the target corporation at 34%, resulting in tax of $3.4 million. Under prior law, any depreciation, investment credit, or LIFO inventory recapture (as well as tax benefit theory ordinary gain items) would be subject to tax at 46%. The remaining balance of the gain escaped tax because, under former sec. 337, such gain was not recognized at the corporate level.

Thus, the difference in tax to the target corporation is $3.4 million, i.e. $3.4 million in tax under revised sec. 336 versus zero tax under prior sec. 337.

Under the new law, after the payment of $3.4 million in tax at the corporate level, the balance of the $16.6 million proceeds (i.e., $20 million less the $3.4 million corporate-level tax) is distributed to the shareholders. The gain at the shareholder level is $6.6 million (i.e., $16.6 million less their $10 million basis in their stock). The tax at the shareholder level would be $1,848,000 (i.e., 28% of $6.6 million).

Under prior law, assuming no depreciation, investment credit, or LIFO inventory recapture at the corporate level, the full $20 million in proceeds would have been distributed to the shareholders. The gain at the shareholder level would have been $10 million (i.e., $20 million less their $10 million basis in their stock). The tax at the shareholder level would have been $2 million (i.e., 20% of $10 million).

Total taxes to both parties would be as follows:

New law:		
Corporate level	$3,400,000	
Shareholder level	1,848,000	
Total taxes		$5,248,000
Prior law:		
Corporate level	-0-	
Shareholder level	$2,000,000	
Total taxes		2,000,000
Difference		$3,248,000
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In essence, the effective rate of tax under the new law is 52.48%.[9] Under the prior law, assuming there were no ordinary income recapture items, the same transaction would have been taxed at 20%. An increase from 20% to 52.48% represents an increase of 162.4% in the effective rate of tax on the same transaction.

Option (4): Asset Acquisition After Which Target Remains in Existence

Assume the same facts as in Option (3) above, except that rather than liquidating the target following the sale of assets, it remains in existence. Assume further that it invests in a portfolio of domestic stocks, and because five or fewer persons own, directly or indirectly, more than 50% of its stock during the last six months of the taxable year, it may be treated as a personal holding company pursuant to sec. 542(a)(2).

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[9] If target has a high basis in its assets, i.e., nearly equal to the purchase price to be paid for the assets, the 34% corporate level tax may be avoided. This would reduce the effective rate of tax to 28%.

The gain under TRA '86 would be taxed as follows: Gain of $10 million (i.e., $20 million less $10 million adjusted basis) is taxed to the target corporation at 34%, resulting in tax of $3.4 million.[10] Under prior law, because the target corporation was not liquidated, a tax of $2.8 million (i.e., 28% of $10 million) would have been imposed at the corporate level. Thus, the difference in tax to the target corporation is $600,000 (i.e., $3.4 million in tax under the new law versus $2.8 million in tax under prior law).

The balance of the after-tax proceeds of $16.6 million is retained in the target corporation. The prior law's 85% dividend received deduction of sec. 243 was changed by TRA '86 to 80% after 1986. Thereafter, sec. 10221 of the Revenue Act of 1987 amended Code sec. 243(a)(1) from 80% to 70% for taxable years ending after 1987 for corporations that own less than 20% of the voting power and voting stock of the domestic corporation. For corporations that own 20% or more of such stock, but less than 80%, the 80% dividends-received deduction will continue to apply pursuant to sec. 243(c). Corporations that own 80% or more of such stock qualify for the 100% dividends-received deduction of sec. 243(b). Thus, for corporations that own less than 20% of the voting power and voting stock of the domestic corporation, the maximum tollgate charge for running dividends through the corporation is 10.2% (i.e., 30% times the 34% corporate rate) for taxable years ending after 1987, versus the prior law's 6.9% (i.e., 15% times the 46% corporate rate). However, the corporation must distribute the remaining 89.8% (i.e., 100 less 10.2%) of dividend proceeds or be subject to an additional 28% penalty tax under sec. 541. If the sec. 541 penalty were applied, the total tax would be 35.34% (i.e., 10.2% + 25.14% (28% times 89.8%)).[11]

The corporation can sidestep the 10.2% dividend tollgate charge, the need to distribute the remaining balance of the dividends to the shareholders, and the 28% personal holding company penalty tax by investing in a portfolio of tax-free municipal bonds. No personal holding company penalty tax applies because there would be no personal holding company income. In addition, there would be no accumulated earnings penalty tax exposure under sec. 531 because, once again, there is no taxable income. Accordingly, the tax-free municipal bond income could continue to build up tax-free.

Provided the shareholders hold their stock in the target corporation until death, pursuant to sec. 1014(a) they can avoid any income tax on (1) the $6.6 million of untaxed appreciation (i.e., the $16.6 million less their original tax basis of $10 million), and (2) any subsequent appreciation due to receipt of tax-free municipal bond income or the increase in value of the municipal bond portfolio due to a fall in interest rates.

By not liquidating, this technique permits avoidance of both payment of the additional 18.48% shareholder-level tax (i.e., 100% less 34% = 66% times 28% = 18.48%), and any subsequent build-up due to tax-free receipt of income and appreciation in value of the portfolio, assuming the stock is held until the shareholder's death.

The total taxes to both parties would be as follows:

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[10] If target has a high basis in its assets, i.e., approximately equal to the price to be paid for target's assets, the 34% corporate level tax may be avoided. This would reduce the effective rate of tax to zero provided the target corporation did not liquidate following the sale of assets.

[11] For corporations that own 20% or more, but less than 80% of a domestic corporation, the maximum tollgate charge for running dividends through the corporation is 6.8% (i.e., 20% times the 34% corporate rate) for taxable years ending after 1987, versus the prior law 6.9% (i.e., 15% times the 46% corporate rate). However, the corporation must distribute out the remaining 93.2% (i.e., 100 less 6.8%) of dividend proceeds or be subject to an additional 28% penalty tax under sec. 541. If not, the total tax would be 32.9%, i.e., 6.8% + 26.1% (28% times 93.2%).

New Law:		
Corporate level	$3,400,000	
Shareholder level	- 0 -	
Total taxes		$3,400,000
Prior law:		
Corporate level	2,800,000	
Shareholder level	- 0 -	
Total taxes		$2,800,000
Difference		600,000
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Mr. GUARINI. Mr. Trevor, partner of Jones, Day, Reavis & Pogue of Cleveland, OH. We welcome you, sir.

STATEMENT OF LEIGH B. TREVOR, PARTNER, JONES, DAY, REAVIS & POGUE, CLEVELAND, OH

Mr. TREVOR. Thank you. As Mr. Dorgan is well aware, there are only three things, really, that I know about the tax laws. The first is that there is one group of my tax partners I call if I want to get a deal done. There is another group of my tax partners I go to if I want to get a deal killed. The third thing I know about the tax laws is TOwer 1-5000, Ernst & Whinney in Cleveland, and they do my tax returns.

I say this to you because, in my judgment, after 27 years of dealing with takeovers in this country, what the Congress effectively has before it is not a tax problem at all. It is a problem about how we change the control of American corporations or how, in fact, we run the American railroad.

So when I got down here last night, I read in yesterday's Washington Post that several Members were disappointed that Secretary Brady and Chairman Ruder, when they were before you on Tuesday, made no specific suggestions about what to do with the merger, acquisition and leverage buyout boom that has dominated the American economy for a long time now.

So I would like to do what Mr. Brady and Chairman Ruder did not do. I'd like to make three specific suggestions to the committee.

Suggestion No. 1 is that you need to simplify the problem in order to make it manageable, and you need to do what Senator Glenn from my home State and Mr. Darman did in the Senate the other day, and you have to find the duck. And the duck here, without any question, is the tender offer technique of acquisitions in this country, and I urge you to focus your specific attention on tender offers.

Suggestion No. 2, therefore, is that you should inquire deeply into what have been the effects of tender offers in this country, the real economic effects, not the propaganda.

And suggestion No. 3 is that, in my judgment, you need to abolish tender offers in the United States by enacting The Abolition of Tender Offers Act.

I will touch on each of these three suggestions very briefly, in turn. To begin with, I think it is clear that if it weren't for tender offers, we wouldn't be here, because virtually every one of the transactions which has caused these hearings to be called—RJR Nabisco, Beatrice, Fruehauff in Detroit and countless others—virtually every one of these transactions has a single common denominator, which is a tender offer or the threat of a tender offer.

Just as you can tell a duck by how it looks and how it talks and how it walks and how it quacks, you can tell a tender offer by its own simple characteristics. A tender offer is a transaction that can be done from start to finish in the short space of 20 business days. It is a transaction that denies to stockholders any collective voice in the most important collective decision that they ever have to face, which is whether they want to sell their own collective asset of control. And a tender offer is a transaction that is absolutely free as a practical matter from any serious regulation by the Securities and Exchange Commission.

What have been the effects of tender offers? Here, in summary form, are some of the relevant facts. Tender offer targets, as Mr. Dorgan has said, are not poor performers. In general they are solid companies, not sick ones. Successful tender offer bidders do not improve the performance of target firms. Hostile tender offers do not benefit the stockholders of the bidder. Hostile bids cause a lot of job losses. Hostile bids cause the dissipation of a lot of pension surpluses.

I would submit to you that, in the face of this evidence, it makes no public policy sense at all to allow tender offers to continue to exist in the United States. And in the face of this evidence, it is scarcely surprising that the Japanese and the West Germans do not do tender offers in their own home markets.

Now, finally, the proper remedy for tender offers, I submit to you, is to abolish them based on the evidence, and you can do it by a simple statute. The short title of the statute would be "The Abolition of Tender Offers Act." Section 1, "No person shall make a tender offer," period. Section 2, "The Williams Act of 1968 is repealed," period. End of statute. It is that simple.

I explain in detail in my written statement why The Abolition of Tender Offers Act will not have any adverse side effects. It will not entrench poor management. It will restore stockholder voting as the proper way to resolve control contests. It will cause the disappearance of most, if not all, of the target company defensive tactics which have quite rightly caused so much concern here in the Congress and in court houses around the country.

And while The Abolition of Tender Offers Act will put merger professionals like me out of work, I think that is a small price to pay—and the only price that has to be paid—to eliminate tender offers from American life. The act would enable America's merger professionals to spend their time helping clients to produce better goods and services and to become more competitive in the world's marketplace, which is what good lawyers and good investment bankers ought to be doing with their time anyhow.

Thank you, Mr. Chairman.

[The statement of Leigh B. Trevor follows:]

WRITTEN STATEMENT OF
LEIGH B. TREVOR

Partner, Jones, Day, Reavis & Pogue[1]

Before the Committee on Ways and Means
of the United States House of Representatives

(February 2, 1989)

Re: Tender Offer Reform

I. INTRODUCTION: DUCKS AND TENDER OFFERS

Out in Ohio where I come from (and in rural Illinois where I grew up), people know a duck when they see one.

Senator Glenn and Mr. Richard Darman were therefore quite right when they agreed in the Other Body several days ago that if it looks like a duck, walks like a duck and quacks like a duck -- then it's a duck. Ducks are popular at the moment because they've helped to simplify the debate on tax policy and the budget.

The debate on mergers and acquisitions requires a similar simplification. In my world of corporate combinations and control contests, there is an exact equivalent of a duck. It's called a tender offer.

Virtually every one of the transactions which is the source of current Congressional concern (whether it's RJR Nabisco, Beatrice, Fruehauf or any of the several hundred others which have occurred in this Country during the 1980s) contains one common element: a tender offer or the threat of one.

If the deal can be done within the 20 business days which Federal law establishes for this purpose, if it is inherently coercive, if it denies to the stockholders any collective deliberation in the process of deciding whether or not to sell control of their company, and if it is, as a practical matter, free from any serious regulatory supervision on the part of the Securities and Exchange Commission,[2] then it's a tender offer -- the ugly duckling of corporate life and law.

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[1] Mr. Trevor is a Partner in the international law firm of Jones, Day, Reavis & Pogue, 901 Lakeside Avenue, Cleveland, Ohio 44114 (216-586-7247). He is Chairman of the Corporation Law Committee of the Ohio State Bar Association and former President of Stakeholders in America (a coalition dedicated to the reform of the Nation's takeover laws). The views expressed in this Written Statement are the personal views of Mr. Trevor.

[2] Wholly without regard to its very strong (and extremely unfortunate) bias in favor of tender offers, the SEC "apparently lacks the resources to police the thousands of [tender offer documents] filed each year." Cardiff Acquisitions, Inc. v. Hatch, 751 F.2d 906 at 912 (8th Cir. 1984), referring to Gearhart Industries, Inc. v. Smith International, Inc., 741 F.2d 707 (5th Cir. 1984).

After more than a quarter of a century in the tender offer trenches, and having lived through several episodes of so-called "reform" of the process, I am totally confident in asserting that no Congressional initiative in this area will work unless it includes the enactment of The Abolition of Tender Offers Act.

II. THE EFFECT OF TENDER OFFERS: WHY THE DUCKLING IS UGLY

For a long time the evidence on the effect of tender offers was ambiguous. It is not so any longer. Here, in summary form, are the relevant facts about hostile tender offers:[3/]

-- target companies are not poor performers.

-- successful hostile bidders do not improve the performance of target firms.

-- hostile takeovers do not benefit the stockholders of the bidder.

-- target stockholders may well be better off in the long run if the hostile bid fails.

-- hostile bids cause a lot of job losses.

-- hostile bids cause the dissipation of a lot of pension surpluses.

-- hostile bids do not improve productivity.

-- hostile bids have made a mockery of corporate governance in the United States.

-- under our legal system, we are putting more than one major American company "in play" each and every week throughout the year, year after year after year.

-- at the same time, however, our principal international competitors -- Japan and West Germany -- do not engage in hostile tender offers in their own home markets.

III. LET'S PUT THE DUCKS BACK IN THEIR CAGES: THE ABOLITION OF TENDER OFFERS ACT

All of this being so, tender offers should be abolished. This abolition must be effected by Federal statute because modern Constitutional theory and the decided cases will not allow the States to do it. Although some technical legal phrases would ultimately be needed to harmonize it with other parts of existing law, the statute would be a simple one -- two short Sections, each made up of a single sentence:

[3/] For a full exposition of the evidence, see Trevor, Leigh B., "Hostile Takeovers: An American Falkland Islands Where The Argies Always Win." (Publication pending; interim copies are available from Mr. Trevor.)

THE ABOLITION OF TENDER OFFERS ACT (1989)

Sec. 1. It shall be unlawful for any person to make a tender offer or a request or invitation for tenders.

Sec. 2. The Williams Act of 1968, as heretofore amended, is repealed except for Section 13(d) thereof [imposing certain disclosure requirements when any person or group acquires 5% or more of the shares of a publicly traded company].

Would such a statute inhibit legitimate corporate combinations? It would not. Tender offers are scarcely ever launched except as the vehicle for a hostile bid or in response to a hostile bid or the threat of one. Truly consensual transactions, preceded by careful planning and effected only pursuant to deliberative stockholder approval, would once again become the standard. Corporate control -- the most valuable collective asset of the stockholders -- would be disposed of only after allowing for the collective voice of the target company stockholders to be expressed in a vote.

Would such a statute "entrench" poor management? It would not. It might have done so years ago when the individual investor was the dominant force in the market. He is no longer. Most substantial public companies now have a majority (and often a very large majority) of their stock held by large institutions: mutual funds, pension trustees, bank trust departments, money managers and the like. These institutions have the resources and, because of the size of their holdings, the incentive to change bad management the way bad management ought to be changed -- by means of a shareholder vote conducted through a proxy contest. Proxy contests are vastly cheaper to mount than are tender offers. Moreover, a proxy contest, no matter how ferocious or prolonged, does not destroy the company. When it is over, there will still be something left for the management (whether incumbent or insurgent) to manage.

That these conclusions are accurate can best be demonstrated by the fact that there were, in the first half of 1988, 17 major proxy contests for control (nearly three times the number that occurred in all of 1987). In nine of these cases (53%), the insurgents achieved, in one form or another, a material part of what they sought -- including five significant financial restructurings. In five others (29%), management got considerably less than 60% of the vote. In addition, there were another 43 sharply fought battles over specific corporate governance issues (poison pill rescission, confidential voting, equal access to proxy materials and greenmail). It is true that the insurgents did not succeed in any of these latter cases. Nevertheless, in many of them the anti-incumbent vote was quite appreciable. For example, 49.1% of Santa Fe Southern Pacific's outstanding shares were voted in favor of rescinding Santa Fe's poison pill. The important point, however, comes from the analogy of warfare: no aggressor will ever take a fair vote seriously if he has a better chance to win by violence. Thus, in 1982, the Argentines had no interest in a Falkland Islands plebiscite. The 20-business-day blitzkrieg will inevitably take priority in corporate control contests for so long as the Congress allows it.

It is commonly and truly said that the outrageous nature of hostile tender offers has produced equally outrageous target company reactions: poison pills, highly leveraged recapitalizations, management-led defensive buyouts and serious issues of conflict of interest and self-dealing, for example.

An inevitable and altogether healthy consequence of the adoption of The Abolition of Tender Offers Act (1989) would be the elimination of most, if not all, of these defensive strategies in most, if not all, cases. These defenses are permitted solely by reason of a special body of jurisprudence which the courts have quite recently created.

The courts, correctly recognizing the hostile bid as a harsh departure from traditional methods of acquiring firms or changing the control of them, have authorized an equally harsh departure from traditional concepts of a director's duty. Although shrouded in classic language from historic opinions issued in a quieter time, the judgments rendered in takeover cases since 1985 have permitted a target board to treat a hostile bid as a unique "threat" to the corporation and its constituencies and therefore to open up with extremely aggressive (and often quite destructive) counter-battery fire so long as the court can be persuaded that the target's artillery barrage is "reasonable" in relation to the "threat" posed. Unhappily but necessarily, "reasonableness" comes down essentially to whether the directors asked the right questions, consulted the right advisors and created the right record of their proceedings. Process takes precedence over products and people. The ultimate consequences of what target directors do or do not do is successfully questioned only in the most unsavory situations. Every student of takeover law must agree that, if the hostile tender offer goes, the resulting defenses go with it. The Abolition of Tender Offers Act (1989) will procure exactly this result.

Only two questions remain.

The first is the question every responsible legislator must always ask: if the Bill passes, who will be hurt?

Because the Bill will not restrict changes in control which target stockholders approve, it does not disadvantage them. Because the Bill will not "entrench," it does not protect target management.

The only adverse impact will fall upon arbitrageurs, speculators, other market players and their advisors. Their discomfiture is a small and tolerable price to pay in order to rid ourselves of the adverse consequences of tender offers which I have already described.

Finally, would serious Congressional consideration of the Bill (to say nothing of its enactment) provoke another Black Monday? It has, of course, been claimed by some that the mere fact that certain restrictive tax provisions were approved by the Committee on Ways and Means in the Autumn of 1987 either caused, or contributed mightily to, the market meltdown. If that is true, then the case for The Abolition of Tender Offers Act (1989) becomes all the more compelling. If the level of takeover speculation had then become so intense that the modest possibility of a denial of the interest deduction on debt incurred to finance hostile deals and related tax law changes could bring the equity markets to the threshold of collapse, then it is as well that the threshold be crossed so that investment in those markets can once again be based on the real progress and realistic prospects of particular firms and specific industry groups. Enactment of the Bill would ensure that such a far-fetched result, if it actually does occur, will happen only once. If the Act does indeed burst a speculative bubble created by the existence of the tender offer process, that particular bubble will never again occur.

IV. IN ANY CASE, THE DUCK OUGHT TO BE TAXED

Because your Committee has responsibility for Federal income tax policy, it would be wrong of me not to add a few words on that subject. I am not a tax expert, but I believe that there are three basic tax points to be made.

First, the time has long since come to discard the principle that the payment of interest on debt is generally deductible while the payment of dividends on stock (which is, like debt, a form of corporate capital) is subject to tax. However, as long as the Internal Revenue Code continues to provide disparate treatment for corporate equity, on the one hand, and corporate debt, on the other, I believe it must do a far more sophisticated job of distinguishing between the two than it does now. "Junk debt," however one defines it, is commonly used in connection with takeovers and defenses against them. A lot of junk debt -- because of its subordinated status, the risks associated with owning it, and/or its potential high yield -- looks a lot like equity to me. I believe that consideration should be given to characterizing at least certain kinds of junk debt as equity for tax purposes, so long as the disparate treatment referred to above continues.

Second, preferred stock generally has many characteristics of debt. However, a corporation issuing preferred stock rather than debt to other corporations is to a significant extent passing the benefits of the interest deduction on to the corporate holder (in exchange for a lower yield than would be provided in the case of a comparable debt security). This is because of the dividends received deduction (generally 70%) available to the corporate holder. For so long as interest is deductible (but dividends are not), I believe that consideration should be given to disallowing the dividends received deduction with respect to dividends paid on debt-like preferred stock.

Third, many targets have capital structures which are not heavily leveraged. Because of that, their Federal income tax bills are -- given the deductibility of interest and the non-deductibility of dividends -- higher than they would be were they more heavily leveraged. Were the leverage in a target's capital structure to be increased by substituting debt for equity, it is reasonable to expect that the fair market value of the target would increase by some multiple of the resulting income tax savings. This phenomenon explains, in my judgment, some part of the current wave of takeover activity. Takeover bidders offer a premium, in cash, over current market values for a target that is not heavily leveraged. They can do so because, in part, they will issue significant amounts of junk debt to help finance the purchase of the target and benefit from lower income taxes. To the extent that Federal tax law so subsidizes takeovers, the law should be changed. Of course, if a takeover bidder can increase the market value of a target by buying it and increasing the amount of leverage in the target's capital structure, existing management can do the same thing by recapitalizing the target instead of selling it. In fact, many actual and potential targets do exactly that -- as a defense to an unsolicited takeover attempt. Thus, if one is concerned -- and I think we all ought to be -- about the degree of leverage that results from takeovers and the risks to the economy thereby posed, one should also be concerned about the degree of leverage that results from defending against the possibility of a takeover. In the defensive situation, the target is increasing the extent of its leverage beyond what it would normally accept (or else it would have leveraged up for reasons other than as a defense). In short, to the extent that the tax law subsidizes leveraged takeovers by favoring debt over equity, it forces many corporations to issue more debt than they would otherwise do in the absence of such subsidies and more than they themselves would generally regard as prudent. It should not be our National tax policy to subsidize leverage of this sort -- which has nothing at all to do with the production of better goods and services or American enterprise's capacity to compete in worldwide markets.

While I hope that you will act upon these and perhaps other relevant tax issues, I cannot emphasize strongly enough -- from the perspective of many years of practical experience -- that complex corporate tax changes targeted at particular perceived abuses rarely alter the substance of business behavior. They are quickly absorbed and mastered by clever, highly compensated professionals who soon find a way to do what their principals want.

Hence the Congress will, in my judgment, have achieved very little if it confines its legislative hand in the takeover area to narrow fixes in the Internal Revenue Code. If tender offers remain permitted commercial transactions, they will continue to occur in increasing numbers -- and essentially nothing will have been done (just as nothing was done in the 98th, the 99th and the 100th Congresses) to recognize, face up to and prevent the adverse consequences of tender offers upon American society. If you only tax ducks, they will shortly reappear as short-necked geese.

V. CONCLUSION: WHO WILL LEAD THE CONVOY?

In evaluating the takeover phenomenon, and the role of tender offers in American law and life, there are two central issues of public policy.

First, does it make any sense at all to put -- as we are now putting -- more than one major American company "in play" each and every week? The answer to that question is "No."

Second, what useful things have tender offers done for America? The answer to that question is "Nothing."

In forming the Committee's view on these questions, I respectfully ask the Members to consider what the great Tory leader, Harold Macmillan -- Prime Minister of Great Britain some 30 years ago -- said to the House of Lords in 1985.

There, at the age of 90, in the last major public act of his long life, and in what is perhaps the finest speech in the English language since the death of Churchill, he gave us the wisest definition of the takeover problem that has yet been uttered:

> "Let us stop these futile, purely theoretical, academic and economic arguments. Let us get back to reality; . . . . We must not be the slowest ship in the convoy. We must be the leader of the convoy or, at any rate, make an attempt to regain the leadership we have had for so long."

He might also have noted, from his own vast experience of the English countryside, that, in any convoy of swimming ducks, it is the weakest who lag behind.

One of the key questions for the Congress in the last days of the 20th Century is precisely the question which Harold Macmillan put to their Lordships some four years ago:

"Who will lead the convoy?"

I respectfully submit to this Committee that the evidence establishes that we will not lead the convoy much longer unless the Congress proceeds -- in the current Session -- to adopt The Abolition of Tender Offers Act.

Mr. Guarini. Thank you very much. You have reduced three long days of hearings to four simple words: Repeal all tender offers.

Mr. Trevor. Yes, sir.

Mr. Guarini. It is a very simple solution. I am wondering, does that recognize the fact there are good leveraged buyouts, that if you want to get rid of all leveraged buyouts of any nature whatsoever, even though those that might get rid of inefficient management, those that might be, make us more competitive and could give us more efficiency in our corporations?

Mr. Trevor. Not at all, Mr. Chairman. My conviction is that if you look at the evidence, which at one time was ambiguous but in my judgment is no longer, and look at the situation as a whole, that the evidence is that tender offers, on balance, produce vastly more harm than good and that transactions of this kind, if they are going to be done, and certainly they should be permitted, ought to be done by careful stockholder consideration at a meeting called for the purpose with full disclosure and an ample amount of time for people to digest that disclosure, and then vote collectively on whether or not they want to sell their company. It is their company. If they want to sell it, no matter who they want to sell it to, as long as the rules are fair, they ought to be able to sell it.

Mr. Guarini. Now, some people have stated over the last few days that tender offers have shaken up some corporations, made the managers think a little smarter about getting their ship in order, that it helps to increase the efficiency of a corporation, and, therefore, makes us more productive.

Do you think that the good that has been done by some leveraged buyout tenders should be eliminated by just categorizing them all off limits, all bad?

Mr. Trevor. I am not saying that all leveraged buyouts are bad. I am saying that, by a great preponderance of the evidence, leveraged buyouts that are done through the tender offer process—with the speed and blitzkrieg effect the tender offer process involves—vastly more often than not turn out to be economically unsuccessful transactions.

I think that, having looked at some 220 major contests for control of public companies in this country since March 1, 1985, a period of about 4 years, it is very difficult to find any significant number of those 220 transactions that have worked out very well. Some of them, of course, disappear and become impossible to track because, once it is over, there is no public reporting responsibility. Others, which look good for a while, after a period of time begin to look less good and, with due respect to Secretary Blumenthal, his own recent numbers as published in the press the other day and his forecast for 1989 are not actually terribly attractive.

Mr. Guarini. I imagine some of the entrenched managements got shook up considerably and had to get their act together. They may have been entrenched, if they were incompetent, they had to start responding more to the stockholders. Don't you think that the threat of an LBO is something that would cause them to shape up?

Mr. Trevor. I would be prepared to concede, Mr. Chairman, that there are undoubtedly, in a universe as large as 220, some cases where that has been true. I can tell you, and I can also stipulate with you, having represented corporate managements for 27 years, that there are some yo-yos out there. I am not here in defense of corporate management. But what in fact you see as a result of the fear of the tender offer process, I think—and others, including Mr. Henry Kaufman from yesterday think—it is a pathological preoccupation in the board rooms and executive suites of this country with tomorrow, and maybe if you are lucky the day after tomorrow, but certainly not next year and the next decade, forget it.

I think that to a large degree that phenomenon results from the tender offer, and I think finally if the rascals are entrenched, if the rascals ought to be thrown out, you throw them out with a proxy contest where the shareholders vote and the shareholders decide who are the rascals.

Mr. **Guarini**. The old-fashioned way.

Mr. **Trevor**. The old-fashioned American way, yes, sir.

Mr. **Guarini**. Mr. Brode, you say we are tending toward using corporations less because of the disparity between corporate rates and individual rates. Are there more subchapter S's being used than before? Can you foresee large corporations wanting to go individual and into partnerships instead of the corporate route because of this disparity?

Mr. **Brode**. That is the thrust of my testimony, Mr. Chairman. I believe that during 1987 and 1988, more than 500,000 corporations made subchapter S elections. They were bailing out in droves, and I submit if you had not passed the Revenue Act of 1987 precluding publicly traded corporations from becoming master limited partnerships, they also would have bailed out in droves. We are not talking about three or four percentage points; we are talking about the difference between 52.48 percent and 28 percent. One does not have to be a genius to realize the differential is so enormous that to run $100 through a corporation leaves you with roughly $48 left, whereas if you ran the exact same operation through a partnership, $72 would be left.

America is going to disincorporate. I believe eventually, unless you take some action to curb the rate disparity, that corporations are going to become extinct like the dodo bird.

Mr. **Guarini**. We would be changing our ways of doing business driven by the Tax Code changes?

Mr. **Brode**. Exactly correct.

Mr. **Guarini**. Mr. Dorgan.

Mr. **Dorgan**. Thank you. I thank all of the panel for appearing. Mr. Trevor, I felt your statement was brilliant, largely because you and I agree on this subject.

Mr. **Trevor**. Thank you, sir, and I agree with you.

Mr. **Dorgan**. There are people who come here and make the case that nothing is wrong with this megamerger activity. Things are just fine, and this is a normal kind of restructuring that goes on every decade or so. We had a fellow testify late yesterday who said "In all of my business life, these sorts of things have happened, and it is not unusual. It is healthy. It is good for America."

I suggested to him that in all of his business life, however many years that was, he had never seen anything like the phenomenon of junk bonds being issued in the magnitude they are now issued. I contended that those junk bonds represent the engine by which this whole LBO system is driven. Without them, the system would collapse.

Can you give me your observation of that?

Mr. **Trevor**. I think that I would simply add a clause to that, which won't be a surprise based upon what I have said. I think that the junk bonds, when associated with the rapidity and blitzkrieg of the tender offer, are together the engine which is driving the current merger boom of the 1980's, and if this fellow throughout his business career has always seen a time like the current time, he must have been born after 1955. I mean, economic history suggests that we have had long periods of time in the 20th century when the country has been free of this difficult problem. There have been three merger booms effectively, one at the turn of the century, another one along the way, and then this one.

And I think that it is quite relevant that a large part of our economic development in the United States was achieved--just as the current economic development in the Federal Republic of Germany and Japan is being achieved without these kinds of transactions and the destructive effects which the evidence establishes these transactions bring to pass.

Mr. **Dorgan**. How did America become a preeminent world economic power without the Boone Pickens out there able to make sure management is efficient, driving and doing the right thing? How did we exist and apparently succeed without them?

Mr. **Trevor**. I think one of the principal reasons why we succeeded is that the system of corporate governance that has prevailed in this country, as indeed in every English-speaking country with appropriate adaptations over 200 years, has been a fair and orderly system of corporate governance that allows needed change to occur in a fair and orderly way, and that these basic principles of corporate governance have been, I believe, not damaged but, in effect, obliterated by the prominence, preeminence to which the tender offer phenomenon has come during the decade of the 1980's.

As little as 20 years ago, the tender offer in this country was completely unknown. And J.P. Morgan and Andrew Carnegie were able to do their things 75 years ago without a tender offer, and they were able to change entrenched management by going to the stockholders and having a vote, and I would suggest that we revert to similar procedures in this country.

Mr. **Brode**. If I could add one point. I think the suggestion has been floated that only inefficient management is being taken over. I am not an economist, but I thought that RJR Nabisco was a fairly efficient company. I don't think any company is sacrosanct today. I think that all companies can be taken over. I think that the phenomenon is not that the stronger are ferreting out the weak, I think that all companies can be acquired through the leveraged buyout mechanism as long as Congress is willing to help or have taxpayers foot the bill.

I came to this revelation when I thought about this 3 or 4 weeks ago. I originally thought the interest deduction was not a large factor, but when you analyze the interest deduction with a Nabisco transaction at a flat 10 percent rate, assuming that they borrowed roughly in the neighborhood of $23 billion, you are talking about

$2.3 billion a year. At a 34-percent tax rate, that means that taxpayers in this country are footing a bill of roughly $800 million.

The question that I have, and I don't know the answer to it is, would the deal have gone forward if the interest deduction were not there? My instincts tell me the answer is no.

Mr. GUARINI. Mr. Brode, thank you for that answer.

Mr. DORGAN. Let me say for Mr. Johnson's benefit, all of us are mindful of the fact there are many transactions—perhaps being classified as restructurings out there—that don't bother us at all, transactions that in some cases result in substitution of debt for equity. I understand that goes on, and it goes on for lots of different reasons.

But anyone who doesn't see the grotesque wild speculation that is occurring in our economy today that has nothing to do with good business and everything to do with greed must be blind. I just don't understand people who have testified in the last couple of days who say, "Gosh, things are just fine. Just like the last 50 years, we have had a few things, but basically things are just fine." I don't understand those people. They are certainly entitled to their opinion.

But I think unless all of us in the public and private sector understand that we have got to put this system of ours back on track and get back to basics, that we will not succeed in what is truly an international marketplace and one that requires competition in which we build better products than other people in order to succeed.

So I am not unmindful of your testimony and the need to do whatever we do very, very carefully. But I am also feeling that what we have to do is dampen these fires of speculation and attempt to reward those people who do good business, or at least attempt to create a system that rewards those who do business the right way, and dampens the speculation that rewards those inordinately whose motive is pure greed.

Mr. GUARINI. Mr. Andrews.

Mr. ANDREWS. Mr. Brode, I didn't hear your testimony, and I apologize for not being here for that, but I want to ask you to address this problem of pass-through entities. You suggested MLP's, for instance, were symptomatic of a problem, and if I remember correctly, about a year ago we had Treasury testify before this committee that their revenue estimates were a $123 billion revenue hemorrhage to the Treasury as a result of MLP's.

We left a carve-out for natural resources as we stopped that kind of partnership creation. And to my knowledge, there has not been any kind of great acceleration within that carve-out of MLP's. That kind of partnership formation has been pretty much killed in the marketplace. Do you disagree with that?

Mr. BRODE. Mr. Andrews, I am not personally familiar with companies within that carve-out situation, but I am certainly familiar——

Mr. ANDREWS. They account for most of the MLP's.

Mr. BRODE. As I understand the grandfathering, it was for those MLP's who became MLP's prior to the effective date of the legislation. In fact, it may have been that those in natural resources were a factor, but my understanding is that all MLP's were protected. Maybe I am incorrect on that.

The point I was trying to make was that because of the rate disparity, this roughly 24.5 percentage points or a reduction of 46 percent, very few entities would wish to practice business in corporate form. They would prefer to practice business at a 28 percent rate of tax, whether it be in a partnership, a subchapter S, or indeed a sole proprietorship.

The whole focus of attention from tax lawyers like me in this country, now that you have eliminated the disparity between capital gains and ordinary income, is how to move income from a corporate rate of 52.48 down to 28 percent for individuals. The mechanism that is used is irrelevant.

I think what Congress was doing was trying to prevent an enormous bailout of all large publicly traded corporations. I had written an article in the June 1987 issue of the Journal of Taxation suggesting that very thing. I never realized Congress would pass laws closing it off, but people flow to the lowest common tax denominator. That is good practice.

Mr. ANDREWS. Maybe we should be looking at all pass-through entities.

Mr. BRODE. The study put together by the Joint Committee, namely, their opening proposal, addresses the very thing we are talking about. To me, LBO's are a side show.

I think the real issue here is that most corporations in one form or another, because of the radical disparity, in rates will seek to disincorporate.

Their first proposal is to have a form of integration between corporate taxation and individual taxation. So when all is said and done, you get down to basically a 28 percent rate of tax. Whether you happen to operate in regular corporate form or whether you operate as a subchapter S or a sole proprietor should be irrelevant. I am basically in favor of that proposal. I don't know what the cost would be, but it makes sense to me. Otherwise lawyers like me are going to be spending an enormous amount of time devising ways to do it.

By the way, we will be successful. We will devise ways to get money from 52 percent down to 28 percent. Bet your last dollar on it that we will be able to do it.

If that is true, why doesn't Congress realize that that is what people are going to do and address that issue. I see leveraged buyouts as nothing more than an efficient way of converting capital taxed at 52.48 percent into capital taxed at only 28 percent. To that extent, even though I don't like LBO's, they are performing a service. They are auctioneers, pedaling the goods off at the highest possible price. They do not intend to operate the corporations. They see there is a gap between the price of the stock at 80 and the underlying value of the company's assets at 100 and then they are gone.

Mr. ANDREWS. One of the solutions Secretary Brady did discuss in his testimony, although he did not recommend that the committee take any immediate action, is on the interest deduction side. Are you suggesting that is what we should cap or we should eliminate?

Mr. BRODE. I think this. My original viewpoint has changed within the last 3 or 4 weeks as I have given a lot of thought to this testimony. My original reaction was to leave things alone. Do nothing.

Like the "Emperor's New Clothes" to say that you are not having acquisitions based on the interest deduction is nonsense. When you run the numbers, the numbers are enormous. The way to test it is, as I said before, if you eliminate the deduction—they won't do the deal.

Mr. **Andrews**. Assuming that is the case, don't we run into other problems—

Mr. **Brode**. Yes, we do——

Mr. **Andrews**. Tangential to this? For instance, in the international marketplace, our ability to compete with overseas investors, our counterparts in Japan, don't we put ourselves at risk if we take any action like that?

Mr. **Brode**. In my written testimony, I said if you are going to address the interest deduction, do it in such a way that it does not put us at a disadvantage vis-a-vis foreign investors. We had earlier testimony from Jack Levin before this panel. He and I agree on this point, that if you disallow the interest deduction for corporate America, what you will be doing is moving the leveraged buyouts offshore. I don't want to see that happen.

But I think that it can be done in such a way so that everyone is treated equally. A foreign buyer would be placed at no greater advantage than an American buyer. I am not saying how I would do it. I think you have creative people on your staff who can.

Mr. **Andrews**. Thank you.

Mr. **Guarini**. Mr. Brode, how are foreign investors, these leveraged buyouts favored under the present status of the tax laws?

Mr. **Brode**. I think the way that it would work is that they would not operate here in the United States. In other words, they would borrow their money, let's say, in Japan. Then they would get a deduction for their interest deduction in Japan against their other taxable income. By the way, of the three largest buyers of U.S. companies this last year, Japan was third on the list. The No. 1 buyer was the United Kingdom with a little over $20 billion, I believe.

The second largest buyer was Canada with something like $18 billion or $19 billion. Japan trailed third at about $12 billion.

Mr. **Guarini**. If Japan gives them the deduction, then Japan is subsidized——

Mr. **Brode**. Exactly correct.

Mr. **Guarini**. That is all right with us if they want to subsidize.

Mr. **Brode**. I don't think it is all right. I don't want to see corporate America put at a disadvantage competitively with a foreign buyer. He should be placed in the exact same shoes as that foreign buyer should be. I think it is possible—I don't have a specific solution to do so—but I think it is possible for you to put corporate America, even though you disallow an interest deduction, for example, on an LBO, to put a foreign buyer in a similar position.

If you let the free market forces work, LBO's will go on, but they will just be moved offshore.

Mr. **Guarini**. Thank you. I want to thank the panel. You have been helpful and instructive.

I would like to call the next two panels together, the Institute for Research on the Economics of Taxation, Norman Ture, president; the Alliance for Capital Access, Erwin E. Schulze, chairman of the board and CEO of Ceco Industries, Illinois; and the American Association of Retired Persons, Judith Brown, member of the board of directors; Employee Stock Ownership Association, Richard D. Mendelson, president; Council of Institutional Investors, Sarah A.B. Teslik, executive director.

Would you please come forward, place your statements in the record. We would appreciate if you would make comments from the statement that you have submitted.

STATEMENT OF NORMAN B. TURE, PH.D., PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. Ture. Mr. Chairman, I am pleased to have this opportunity to present my views to you on the tax policy aspects of mergers and acquisitions. I believe that there are three principal policy questions on which the committee should focus its attention. One of these questions is whether any provisions of the present Federal income tax are themselves responsible for the wave of changes in corporate ownership and structure which are generally involved in highly leveraged financing.

For the sake of brevity, let me refer to these as CR's. If it could be established that CR's are undertaken only or principally because of tax considerations, one might well question whether those tax rules meet the test of tax neutrality or instead send distorting signals to the market and therefore should be amended.

A second question is whether these highly leveraged CR's entail significant losses of tax revenues for the Federal Government. If it were determined that such revenue losses result because various provisions of the current tax law subsidize CR activity, the committee would do well to design appropriate changes in these provisions.

A third question is whether various provisions of existing tax law exert a bias in favor of one or another form of corporate finances. This is an urgent matter that I believe warrants the committee's attention irrespective of whether these provisions are found to be significant in connection with CR's.

Others who have appeared before you have testified at length about the good and perhaps not so good aspects of CR's. I do not dwell in my testimony on that question. I should point out to you that the data that measure the aggregate performance of the economy do not show any adverse effects that can be objectively attributed to CR's and the high yield leverage financing of them.

If you look at Federal Reserve data, as I have recently, they show no significant recent departure in debt-equity ratios from the long term, very modest trend rise in this ratio. Although interest costs have increased in relation to gross income of nonfinancial corporations, this rise, too, represents the continuation of a very long standing, very modest trend.

In my judgment, tax considerations are not the driving force behind CR's. The commonly asserted nexus between tax policy and CR's is that because interest is deductible while dividends are not, the tax law subsidizes debt financing upon which CR's are alleged to depend. The current tax provisions do not subsidize debt. Instead, they penalize equity. The nondeductibility of dividends imposes a double tax on returns-to-equity investment in corporations.

The differentially heavier tax on equity returns distorts corporate financial structures. There should be little question about that. This distorting influence was reduced by the tax rate reductions enacted in the Tax Reform Act of 1986. Tax developments appear to run counter to the increasing use of high-yield bonds. If CR's are deemed to depend on high-yield bond financing, one must conclude that tax policy has asserted a decreasing, or perhaps prohibiting, influence on CR activity in recent years.

CR's have more likely generated tax revenue gains than revenue losses for the Federal Government. CR's result in substantial capital gain realizations that exceed losses in the market value of the bonds of the target and acquiring companies outstanding before the CR. These net increases in taxable income are only partially offset by the increase in interest deductions net of the increase in interest income received by the lenders.

The committee should be concerned about the differential tax treatment of corporate debt and equity and should seek appropriate remedies. These should seek to reduce the burden on equity rather than raise the tax load on debt. Limiting the deductibility of interest would increase the cost of debt capital and would also raise the cost of equity capital.

Proposals to disallow deductions for some fraction of interest payments while allowing partial deduction for dividends are misfocused. Leveling the playing field does not call for double taxing interest to match the double tax on dividends. The focus should instead be on removing the tax penalty on dividends and on returns to equity.

A constructive initial step would be to permit the deduction of some fraction of the dividends paid on net new issues of common stock. A companion measure would be to reduce the tax on capital gains realized on the disposition of corporate equity investments.

[The statement of Norman B. Ture follows:]

THE TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

STATEMENT OF NORMAN B. TURE, PRESIDENT
THE INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION
TO THE
COMMITTEE ON WAYS AND MEANS

February 2, 1989

Mr. Chairman, members of the Committee, I am Norman B. Ture, president of the Institute for Research on the Economics of Taxation (IRET). IRET is a public policy research organization, exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code. The testimony I am presenting to the Committee today represents my views and are not necessarily those of IRET, its Board of Directors, contributors, or others associated with the organization.

What Is At Issue?

I am pleased to have the opportunity to present my views concerning the tax policy implications of corporate acquisitions, mergers, and leveraged buyouts (permit me to use the term "corporate restructuring" - abbreviated herein as CR - as a shorthand substitute designating all such changes in corporate ownership and identity). Many of these CRs have proved to be very dramatic events, capturing the media's attention, hence that of a much wider audience than the financial market participants who are directly or indirectly involved in them. One consequence is that the issues have tended to become somewhat blurred, and this has, in turn, tended to confuse the question of why the public policy interest should be engaged by CR activity. If this Committee is to determine whether public policy action within its jurisdiction should be undertaken, I respectfully submit, it should be at pains to identify the issues that are presented by CRs.

CRs' Alleged Capital Offenses

CRs have been widely and frequently indicted on a long list of alleged economic offenses. The usual litany starts with the assertion that a CR is undertaken by greedy persons in pursuit of the financial gain they seek to obtain from acquiring ownership and managerial control of the target business. These persons, allegedly, grossly disregard the profitability, efficiency, and growth of the acquired company, sacrificing these long-term goals in the interest of maximizing their own short-run gains. The consequences of the pursuit of short run gains by the new management, it is claimed, include plant closings or divestitures, massive personnel layoffs and pay cuts, sharp cutbacks on research and development and on investment for expansion and modernization, less productive uses of the company's labor and capital resources, hence increases in production costs.

Because CRs are generally implemented by substantial increases in the target company's debt:equity ratio, the customary charge is that this results in a very large increase in the share of the company's cash flow that needs to be devoted to debt service, thereby eroding the income available for the shareholders of both the acquired and acquiring corporations. The increased leverage, it is claimed, also weakens the ability of the company to withstand business reverses, hence exposes them to a greater risk of bankruptcy. This enhanced riskiness, it is asserted, is quickly reflected in a lower bond rating, hence higher interest rates to be paid by the company on any new debt financing it may have to undertake subsequently.

The more widespread the CR activity, it is claimed, the more aggregative are these adverse effects. Thus, it is frequently claimed that CRs are at least partly responsible for rising interest rates, economy-wide job losses, inadequate growth in productivity, hence impairment of the competitive position of American businesses in the world market, and a gravely weakened capacity of the whole private sector to ride through the next recession. Perhaps the least serious charge that is commonly made is that CRs entail a highly wasteful use of the nation's saving at the expense of growth-generating capital formation.

Opposing Views About CRs

I won't attempt in this testimony to examine these charges in detail. As the Committee is well aware, there is an extensive and growing literature that, on both analytical and empirical grounds, challenges the views that CRs are, in their very nature, economically dangerous or damaging. Indeed, much of this literature points strongly in the opposite direction, arguing that CRs or the threat thereof result in better management, more productive use of the company's resources, expanded employment opportunities and greater returns to shareholders.[1] Several of these investigations have quantified the substantial gains realized by shareholders of the target company, noting that these greatly outweigh the losses to bondholders.

The data measuring the aggregate performance of the economy, moreover, give no credence to the views that the increasing number and magnitude of CRs have damaging economy-wide effects. Nor do the data support the view that the extensive leveraging relied on to implement CRs has significantly affected the financial structure of U.S. corporate business. From the early 1960s through 1987, for example, no statically significant trend in corporate debt:equity ratios is to be found when debt is measured at par and equity is measured at its current book value. In fact, the ratio in 1987 was only slightly higher than in the late 1960s and early 1970s. Using market valuations of both debt and equity, a statically significant but very slight rising trend in the ratio of debt to equity (about 1.1 percent a year) is found, but the current level of the ratio is well below that of the years 1974-79, inclusive.[2]

It is indeed true that interest costs have increased as a fraction of the gross income of nonfinancial corporations. The increases in recent years, however, are best seen as the continuation of a very long-standing trend. From 1948 through 1987, net interest as a fraction of the gross domestic product of nonfinancial corporate businesses in the United States increased on the average by 0.1 percentage points a year; this trend rate of growth is statically highly significant.[3]

I do not mean to suggest that these findings urge that public policy should be structured so as to promote CRs, leveraged or not, but unless a convincing case, well supported by solid facts and analysis, can be made that CRs are per se economically damaging, neither should public policy be structured to impede CRs. By the same token, unless it can be convincingly demonstrated that institutional flaws, whether in our tax laws, regulatory provisions or procedures, or financial market arrangements systematically induce a volume of CR activity that would not otherwise occur, public policy makers would be well advised to allow the operations of the financial market and the decisions of the market's participants to determine the amount and character of this CR activity.

Federal Income Tax Factors, High-Yield Bonds, and CRS

It is quite commonly asserted that there is, indeed, a flaw in the federal income tax that has contributed substantially to CR activity. The prevalent view is that CRs depend critically on so-called "junk bond" financing and that the extensive use of highly-leveraged financing to implement CRs in turn depends on the tax subsidy of debt financing by allowing the deductibility of interest. It is this view that gives the Committee on Ways and Means governance in this matter. The critical issue for the Committee, therefore, is whether there is in fact any such tax subsidy of debt as opposed to equity financing that affords an unnatural impetus for CRs.

There is little question, I believe, that the availability of "junk bond" financing and the marketability of these instruments have facilitated the financing of CRs. Some observers appear to have put a twist on this relationship, implying that CRs are the product of the financial institutions that have developed and seek to market high-yield bonds, that CRs are undertaken only to provide the occasion for recapitalization of the restructured firms and to provide a market for these high-yield bonds. No such implication is warranted, in my judgment.

The firms that have developed and are marketing these bonds have, as a group, apparently made a great deal of money from this activity, but the successful marketing of these bonds clearly depends on investors' assessment of the capacity of the company on whose behalf they are issued to service them. If investors believe that the risk of partial or complete default outweighs the high yield these bonds offer, the bonds won't be purchased, and if the CR depends on this financing, it will prove to be abortive. Unless one believes that financial market participants are all gullible fools, incapable of evaluating earnings prospects or are in the pockets of high-rolling CR activists and their brokerage firm allies, the notion that CRs occur solely at the behest of high-yield bond dealers is simply untenable.

Tax Subsidy of Debt Financing or Tax Penalty on Equity?

If CRs are made possible only by the availability of high-yield bonds to finance them and if this financing, in turn, depends on tax subsidization of debt, this subsidy should be removed, no matter what would happen to CR activity. The critical question, to repeat, is whether the differential income tax treatment of the returns on debt and equity contracts subsidizes debt finance.

The Tax Bias Against Equity

The answer is quite the opposite. It is, I believe, well established and widely accepted that the income tax is inherently biased against saving and in favor of current consumption. Income is taxed when it is earned and realized; if after-tax income is used for current consumption, no additional income tax is imposed. If the after-tax current income is saved, however, the returns on the saving are subject to another round of income tax. In addition to this basic nonneutrality, numerous provisions of the present income tax law also distort the relative prices or costs of differing uses of saving. [4]

One of the greatest culprits is the corporate income tax that imposes double taxation of saving committed to a corporation by an equity contract. As a general rule, this additional violation of tax neutrality is avoided in the case of debt contracts, because the interest paid by the debtor, corporate or otherwise, is deductible.

In effect, the income tax imposes a selective excise on equity investment in a corporation but does not impose it on debt incurred by the corporation. This differential treatment should certainly not be characterized as affording a subsidy for debt finance, but as imposing a negative subsidy or tax penalty on equity financing. If an excise tax were imposed at a given rate on, say, all consumer durables except, say, refrigerators that were taxed at a lower rate, one certainly wouldn't assert that refrigerators were subsidized by the excise tax; indeed, purchases of refrigerators would be penalized relative to purchases of non-durables and services on which no excise is levied.

The Tax Distortion of Corporate Finance

The differential income tax treatment of returns on debt and on equity must indeed distort the composition of financing, hence business capitalization, not because debt is subsidized but because equity is penalized more than debt. The degree of bias exerted by this differential treatment depends on the level of the tax rates in both the corporate and individual income taxes. The higher the tax rates, clearly, the greater the distorting influence of the differential tax provisions.

In this connection, it must surely have been called to the Committee's attention that the very substantial rate reductions enacted in the Tax Reform Act of 1986 significantly reduced the effective tax bias in favor of debt and against equity financing. The elimination of the reduced rate of tax on capital gains offsets that favorable effect in some degree, but it is reasonable to assume that the net effect of the 1986 legislation is a less severe tax bias against equity compared with debt than had earlier prevailed. Insofar as debt:equity ratios have increased since 1986, whether or not as a result of CRs, tax policy can hardly be held to be responsible. On the contrary, tax policy has moved toward reducing the anti-equity bias in the income tax, thereby reducing the impetus for debt as opposed to equity financing.

Tax policy does not seem to have been a significant influence in the development and increasing use of high-yield bond financing. If CRs, as often asserted, depend on the availability of such financing, one must conclude that tax policy has exerted a decreasing influence, if any, on CR activity. Other factors and developments should be sought to explain the increase in this activity.[5]

This is certainly not to suggest that the differential tax treatment of debt and equity returns should be a matter of no concern to the Committee. It is difficult to discern any acceptable goal of tax policy that is effectively pursued by penalizing equity financing, certainly nothing that would warrant incurring the costs this penalty imposes.

The Tax Penalty on Equity and the Cost of Corporate Capital

One of the more damaging of these costs is the increase in the cost of capital that results from this tax treatment. Because dividends are not deductible, the corporate income tax is an incremental tax withdrawn from the earnings on the equity investment in the corporation. The fact of this additional tax does not persuade equity investors to accept a lower reward for saving in this form. Instead, it results in their requiring a higher pretax return on their investment so that their after-tax return will be maintained.

This cost increase is not confined to capital financed by equity. Shifting to debt finance to avoid the tax penalty on equity tends to increase the cost of the company's debt service. Debt finance, too, is made more costly than otherwise.

The increase in the amount of debt in the company's capitalization and the greater cost of servicing that debt, moreover, increases the risk that returns on equity will be eroded. This impels shareholders to seek higher pretax returns on their investment than would otherwise be needed. If corporate management fails to use the firm's resources in such a way as to provide the additional return, the market value of the company's shares will fall until the required risk-adjusted rate of return is achieved. In short, the tax distortion of the relative costs of debt and equity generally leads to higher costs of both.

Eliminating, or at least reducing, the tax bias against equity should not be sought by imposing the same sort of penalty on debt financing that is currently borne by equity financing. It is not a "level playing field" per se that should be the policy objective, but a playing field all parts of which are correctly configured. The way to eliminate the differential tax treatment of refrigerators and all other consumer durables, in the example above, is not by imposing or raising the excise tax on refrigerators but by eliminating or reducing the tax on consumer durables generally.

Economic Effects of Limiting Interest Deductibility

Irrespective of the way in which it is achieved, limiting the deductibility of interest should be counted on to have highly undesirable economic effects. It would certainly raise the cost of capital confronting all businesses, regardless of the type of financing relied upon. If any part of the interest payment is to be subject to tax by the payer, the capital the acquisition of which is debt financed would have to produce a higher pretax return than otherwise. If it did not, either the yield afforded the bondholders would have to be reduced or the after-tax return on the equity would fall. Nothing about exposing bond interest to tax in the hands of the interest payer would induce bondholders to accept a lower yield; if anything, the tax-induced increase in the cost of servicing the debt by the borrower would enhance the risk of holding the bond and lead lenders to require higher pretax yields in order to assure the same risk-adjusted rate of return on their bond holding.

By the same token, nothing about the limitation of interest deductibility would in itself increase the return on equity capital or induce shareholders to accept a lower rate of return for the same amount of holdings. Insofar as debt financing were deemed to be essential, the tax-induced increase in the cost of debt service would reduce the amount of earnings available for rewarding equity capital and increase the risk of equity investment. This would impel equity investors to seek higher pretax returns to restore the returns on their investment and to compensate for the greater riskiness of their investment.

Selectively Limiting Interest Deductibility

These adverse consequences, moreover, could not be avoided by imposing limitations on interest deductibility selectively. One suggestion is to confine the limitation to high-yield bonds, presumably because they have been so extensively used in CRs. The objective of this selective curb on interest deductibility presumably is to reduce the extent of CR activity without adversely impinging on other "legitimate" uses of debt financing. In addition, such a curb, presumably, would prevent the run up of interest costs that allegedly imperil the leveraged firm relying on these high-yield instruments and that erode its taxable income and lose the Treasury tax revenue. I do not believe that either of these objectives is appropriate.

As indicated earlier in my testimony, I do not believe that the vote is in on the goodness or badness of CRs, however they may be financed. There is, as yet, at any rate, no persuasive body of evidence to urge that CRs, no matter how heavily debt financed, entail adverse economic consequences that call for public policy efforts to limit them.

The level of the yields on the debt instruments used to finance CRs certainly doesn't represent deliberate efforts on the part of the borrowers to pay "excessive" amounts of interest, despite the fact that these very large interest costs may drastically reduce the restructured company's taxable income and tax liability. Unless the marginal tax rate were 100 percent or higher, after all, each dollar of interest cost leaves the company poorer, not richer. The level of these yields, instead, reflects investors' assessments of the risk of committing funds to the borrower. It is difficult to see why public policy should interfere, seek to alter investors' judgments, or prohibit investors from willingly accepting these risks.

Revenue considerations certainly should not be determining factors. For one thing, a strong argument can be made that CRs have been revenue raisers, particularly after the effective date of the Tax Reform Act of 1986. The most signal feature of CRs has been the very substantial increase in the market value of the target company's equity. The capital gains realized when the restructuring is implemented results in revenue gains that, at worst, are only partially offset by the increase in interest deductions net of the increase in interest income resulting from the increased leverage of the restructured business.

In any event, whether CRs leveraged with high-yield bonds result in revenue gains or losses is not the relevant question; the appropriate concern is whether there is any reason, based on fundamental tax principles, to question the legitimacy of the interest deduction. **I know of no principle of taxation that argues for determining the deductibility of interest by reference to the rate at which it is paid.**

Even disregarding these objections, it is difficult to see what kind of narrowly-focused limitation could be designed that would be workable. What other than perfectly arbitrary dicta would delineate the characteristics of a debt instrument the interest on which would qualify as deductible? At what level would the yield on any given debt issue be deemed to be "too high?" What meaningful criteria could be adduced to determine the "right" yield? What tax policy principle could be identified, indeed, to validate curbing the deductibility of interest on any debt the terms of which are determined in the market?

Attempting to curb the deduction of interest on some kinds of debt but not on others would confront formidable problems of identification and definition. The complexity and costs of compliance and enforcement that would attend attempts to distinguish among differing types of borrowing should themselves deter moving in this direction, even ignoring the adverse economic consequences. I am sure that other witnesses, particularly Secretary Brady, have called the Committee's attention to these problems.

Another approach that has received some attention would focus on rigorously defining debt and differentiating it from equity. The objective, presumably, would be to disallow the deduction of interest on those instruments that were deemed to be more nearly equity than debt contracts.

In a dynamic financial system that accommodates the financing demands of an enormously diverse business community, a very wide variety of financing devices is to be expected. It would be truly astonishing if the result were not a great number of similarities as well as distinctions among these devices. The need for sharp distinctions among them does not arise from unwarranted or overly generous treatment of those debt instruments that may be thought to be on the borderline between debt and equity; it is impelled, instead, by the punitive treatment of equity. Obviously, if payments in service of equity contracts were treated the same way as debt service, i.e., correctly, there would be no occasion for attempting to make these often very difficult distinctions.

Even were it possible to implement this approach without adding appalling complexity to an already frighteningly complex tax law, the result would be damaging. Implementation would mean that some payments now treated as deductible interest would instead be subject to the corporate income tax. As shown above, this would raise the cost of capital to the affected companies.

Any limit on interest deductibility sought allegedly in the mistaken interest of leveling the playing field would, in fact, seriously tip the playing field in one major respect. However effective any such limit might be in inhibiting debt financing of CRs, and ostensibly in reducing the extent of CR activity by U.S. citizens, it would be largely if not entirely ineffective in constraining foreign persons' use of debt financing to restructure American companies. I do not believe that foreigners should be prevented from acquiring businesses in the United States, but neither do I see any reason to advantage foreigners in competition with Americans for the ownership of U.S. businesses.

Across-the Board Limits on Interest Deductibility

Possibly in response to these difficulties of definition and identification, a number of proposals have emerged for imposing some across-the-board limitation on the deductibility of interest. One such proposal is to disallow the deduction of some fraction of a company's interest costs and devote the resulting increase in tax revenues to offset the revenue lost by allowing the company to deduct some fraction of its dividends.

This Solomon-like cut-the-baby-in-two approach is simply misfocused. The deficiency in the tax law is not that interest may be deducted but that dividend payments may not be. Ignoring the various provisions in the present law that limit interest deductibility in certain situations, the present law in general affords the correct tax treatment of interest. This treatment should not be sacrificed on "level-the-playing-field" grounds, if this means leveling up to the tax rate on dividends. The focus, instead, should be on removing the present law's penalty on equity financing.

Implementing this 50-50 approach, moreover, would have particularly harsh results for new and for small, rapidly-growing companies that often depend on borrowing to obtain the financing they require. The higher costs of borrowing they would face would not be significantly offset by the lower cost of more nearly correct treatment of equity. Such companies would, therefore, confront relatively and absolutely higher costs of capital. This certainly would not be a sought-after result.

Reducing the Tax Penalty on Equity

Instead of seeking ways to limit interest deductibility, the Committee would do well, I believe, to look for means of reducing the excessive tax on the returns to equity. Eliminating the double taxation of dividends by allowing them to be deducted in computing a corporation's taxable income is an appropriate objective. The income tax law generally observes a basic income tax principle that calls for allowing deductions for payments made for production inputs. Corporate businesses, accordingly, are permitted to deduct the payments they make for labor services; they are also allowed to deduct their payments to lenders for capital services. Deductibility should be extended for payments made to shareholders for capital services.

Making dividend payments fully deductible would probably entail a significant loss of tax revenue, as conventionally estimated, that is without taking account of feedback effects on economic activity. It is likely that this static revenue estimate overstates the revenue loss, even disregarding feedback effects, because it fails to take into account the increase in the market value of outstanding equity that would result and, therefore, the increase in capital gains tax revenue obtained when these gains were realized. In any case, in this era of great concern about federal budget deficits, extending deductibility to all dividend payments may well appear to be an unrealistic proposal.

Partial Deduction of Dividends on Net New Common Stock

A significant step in the right direction, however, can be taken at a much lower cost of tax revenues to the Treasury. This step would be to allow a deduction for some fraction of the dividends paid on net new common stock issues. The revenue effect of this change in the tax law clearly would depend on the increase in total corporate capitalization. This increase would occur in response to the lowered cost of equity capital that, in turn, would result from a reduced tax barrier to dividend payout and a larger volume of dividend distributions. In all, it is likely that the revenue loss, even measured on a static revenue basis, would be quite small.

Reduce the Capital Gains Tax Rate

A companion measure would be to reduce the tax on capital gains, at least those realized on the sale of corporate equity shares. The equity investor in a corporate business obtains the returns on this investment either in the form of dividends or, alternatively, by realizing capital gains upon the sale of his shares. These capital gains are largely generated by the corporation's retention of profits remaining after payment of the corporate income tax. If these retentions are invested in assets at least as productive as those that produced the current income stream, the market's valuation of the equity will increase in an amount equal to the present value of the expected increase in the corporation's earnings after corporate tax. Reducing the tax on such capital gains, therefore, reduces the double taxation of income generated in corporate businesses. For this reason, reducing the capital gains tax rate would raise the market value of capital assets.

The effects of reducing the capital gains tax rate on the cost of corporate equity capital closely parallel those from providing for the deductibility of dividends. In essence, either tax change would reduce the pretax yield on equity investment required by equity investors to obtain an after-tax yield sufficient to warrant their making the investment.

There has been much debate about the revenue effects of reducing the capital gains tax rate. Much of the dispute has centered on the effect of the rate reduction in unlocking long-held capital assets. This transaction effect may well be quite substantial, at least in the short term, but it embraces only a part of factors that would affect the revenue flowing into the Treasury.

As noted, reducing the capital gains tax rate would very promptly raise the market value of capital assets. Tax revenue changes, therefore, would reflect not only the increase in capital asset transactions but the larger capital gains realized in these transactions. Furthermore, because reducing the capital gains tax rate would reduce the cost of capital, the ultimate effects to be expected include a larger stock of capital and a higher capital:labor ratio, greater labor productivity and higher real wages and employment, hence greater output and a larger tax base than would otherwise prevail. These long-term gains for the economy should weigh at least as heavily in policy makers' considerations as the near term effects on tax revenues in evaluating these proposed changes in the tax law.

Conclusion

In conclusion, I respectfully urge the Committee to reject proposals for any sort of limitation on the deductibility of interest. A persuasive case has not been made that CRs have injurious effects on the economy and therefore require changes in public policy to limit CR activity. Much evidence has been amassed and presented to this Committee and others that CRs contribute to more efficient corporate management and more productive uses of the resources at corporations' disposal. Should the Committee concludes that CR activity is a matter for it to address, I strongly recommend that it focus on reducing the existing income tax penalties imposed on equity financing rather than attempt to impose those penalties on debt financing, as well.

[1] A partial listing of important contributions to this literature is provided in the attached bibliography.

[2] Data are from the Board of Governors, Federal Reserve System.

[3] The trend change in this ratio was computed using an ordinary least squares regression of the annual ratios of net interest to gross domestic product on time, from 1948 through the third quarter of 1988. Data on gross domestic product of nonfinancial corporations and their net interest payments are in **Economic Report of the President**, January 1989, Table B-12, page 322.

[4] For an extended discussion of these propositions, see Norman B. Ture and John B. Egger, **Corporation's "Fair Share" of Federal Taxes**, A Study Prepared for the National Chamber Foundation (Washington, D.C., 1988), pages 25 -39 and 42 - 45.

[5] For identification of some of these other influences, see Stephen Kaplan, "Management Buyouts: Efficiency Gains or Value Transfers?" paper presented at the New York University's Salomon Brothers Center, Conference on Financial-Economic Perspectives on the High-Yield Debt Market, December 8-9, 1988.

STATEMENT OF ERWIN SCHULZE, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, CECO INDUSTRIES, OAKBROOK TERRACE, IL, ON BEHALF OF ALLIANCE FOR CAPITAL ACCESS

Mr. GUARINI. Mr. Schulze, the Alliance for Capital Access. Welcome.

Mr. ERWIN SCHULZE. Thank you. Good afternon. My name is Erwin Schulze. I am chairman and chief executive officer of the Ceco Corp. located in Illinois.

I am appearing on behalf of the Alliance for Capital Access, an association of over 100 companies nationwide which issue or invest in high-yield bonds.

I came here because I have been told, and I think this is true, that I am one of the few chief executives that has appeared before you who has actually gone through an LBO and is still running the company acquired. I also happen to be chairman of the Illinois Manufacturing Association, the oldest and largest State manufacturing association in the United States.

As a result, I have a good deal of familiarity with what is going on in Illinois and in related States in the Midwest. I would like to talk about some of the things that I have read in the newspaper concerning LBO's which seem to me to be at odds with my experience with the way they really work.

First let me say that Ceco is a major purveyor of concrete-forming services in the United States. We are the oldest company in that industry, having been formed in 1912. We are also a major manufacturer of steel doors and of metal buildings, and we employ about 6,000 people around the United States.

The company went public in 1965 when the founding family sold 80 percent of their interest in the company and retained 20 percent. During the 1970's, because Ceco was a cyclical company and despite the fact that we believe it was well-managed, it was not well-valued in the stock market.

As a result, the value of the company to the stockholders appeared to be less than what they thought the true value of the company was. They asked me to come in and manage the company in 1980 and do something about it.

I restructured the company, focused it more on the construction industry and the process of that. We improved the market value of the stock.

In 1985, the family came to me and said they were interested in diversifying their holdings in the company. That meant either that they were going to sell, which would make us a plum for acquisition by a raider, or we would have to try to take the company private.

We did the latter. In 1986, it was a transaction that involved about $200 million. One of the points here that I would like to make is that our transaction in Illinois was a big transaction. Of course, it pales by comparison when you talk about RJR or things like that.

But $200 million was a big transaction. In 1986, the acquisition by the buying group of Ceco spawned four more LBO's when we sold off operating regional units in order to reduce our debt load.

The largest one was $15 million, so we are not talking, in my judgment, when we talk about LBO's, about huge transactions. We are talking about the ability of smaller units in this country to be owned by the people who manage them.

This, I think, is a very good thing, not a bad thing. One other point that should be made is that when you go through an LBO, it has been said, that somehow or another employment is lost. In our case, employment has been gained. Not only is the ongoing company of Ceco employing more people today than we did in 1986, but each of the units that we sold is now employing more people than they did in 1986. So from that standpoint, things are better.

Another point that I should make here is that they are not better because the economy is better. We are in the construction industry. The construction industry peaked in 1985. We are now in the third year of recession. So these companies have been able to do well in a recessionary period.

One of the major benefits that we have achieved by becoming private is that I now have, for the first time in 25 years of running a public company, the ability to concentrate on the long term. This you can do in a private company, whereas in a public company we are at the mercy of the Wall Street's evaluations of what our next quarter's earnings ought to be.

I think when companies go private, they can plan for the long term much more effectively than they can in the public sector unless, of course, you are a giant company, and I can't speak for the giant companies.

Another item I should mention is one Dr. Ture just mentioned. That is that in the consideration of our LBO, tax implications really never came into play. They had to be there obviously somehow in the evaluation of the company.

This was not a tax transaction or tax motivated transaction. I believe by looking at the companies that we spawned off which are now functioning well and by looking at our own company, the net effect of the LBO is the more effective use of productive capital. That is what I really think happens when you break up American industry into smaller parts which are owned by the people who manage and run them.

Another item is whether or not the people who are involved in the transactions get rich. I can't speak for the investment bankers, nor the commercial bankers who also get very high fees, but I can speak with respect to the managers and the owners of our company.

We did our transaction and spread the equity among 176 managers of Ceco. These are the people now, together with family, who own the company. The only way we are going to get paid for that ownership is by building value. That is over the long term, not over the short term. So we are engaged in trying to build up the value of this company over the next 5 or 10 years.

That is what we are trying to accomplish. If we are successful, it is true, we will make a good return on that investment. But if we are not, we won't. In the interim, no one has gotten rich.

One other item that I should mention is that there has been some talk—I think the Speaker this morning talked to this issue—

that the world is going to have a lot of LBO's in trouble as soon as we are in a recession.

Somehow or other this is going to be the trigger point to determine whether or not these highly leveraged companies can really survive. I have two points I would like to make about that.

Number one, many of us, particularly those in the Midwest, were unaware that we were in good times. Most of the Midwest concrete forming companies only came out of the recession last year when the dollar started falling and exports started increasing.

Our own company in the construction industry has been going through a downturn for the last 3 years, and we expect it to continue for the next two. In our model of our leveraged buyout we put in two recessions because we knew we were going to have to take that into account in our cash flows.

I have managed public companies since 1965 and only had the luxury of managing a private company for the last 2 years. But in all my experience, whenever there was a recession, I was awash in money.

The reason for that is very simple. The big capital invested in the companies is not invested in the equity base. It is invested in working capital: your inventories and receivables.

Let's say my inventories and receivables were $150 million, let's say, and my sales were $300 million, and I lost half of my sales—that happened to me in 1974, which is a terrible thing to happen, but we still made money. Nonetheless, that did in fact happen.

I was not in trouble in 1974 meeting my debt obligations. The reason for that is my receivables and inventory went down 50 percent and generated $75 million in cash. So I was awash in money during that period of time. The problem with servicing your debt is going to occur not in the recession, but when you come out of a recession into boom times because every dollar of additional sales is going to cost you 50 cents in working capital.

That is when the problems arise. So I don't understand how somebody could say that the recession is going to trigger defaults by LBO's. It doesn't make any sense to me.

The final point I would like to make is that debt capital is important for small businesses in America, and despite the fact that we were once a Fortune 500 company, I still consider us small. Certainly those 5,000 members of the IMA which are mostly small companies, depend upon debt for capital.

Equity doesn't make any sense to those companies because the equity is not property value. All we are going to do is make those companies subject to acquisition by somebody else if we force them to go to equity.

Debt is the way we go. Ceco, a large company by some definition, small by others, was not an investment grade company. Hence, when we issued debt, it was junk debt. I am talking about 1987. I am not talking about today.

The only people we could get money from were the insurance companies and pension funds who tied us up with all kinds of restrictions because we wanted money for 15 years since it was long-term investment. The high yield bond market revolutionized debt capital in this country and enabled many small companies to have access to debt which they would not have otherwise.

That is one of the reasons why you are seeing the growth of small companies. They can get the debt capital. So high leverage is not bad in the way I look at it. I think it is good. I am concerned that if this committee looks at the abuses of LBO's which I am sure happen, and at the inordinate fees, which are improper, that we don't get carried away and throw the baby out with the bath water.

It seems to me that one of the problems with proposals on debt and interest deduction is that in the end the only companies that will be saved and helped are the Fortune 100 companies.

I don't want to have this committee pass a Fortune 100 protection act.

[The statement of Mr. Schulze follows:]

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TESTIMONY OF MR. ERWIN SCHULZE
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
CECO CORPORATION
ON BEHALF OF
THE ALLIANCE FOR CAPITAL ACCESS
BEFORE THE
WAYS AND MEANS COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

FEBRUARY 2, 1989

Good afternoon. My name is Erwin Schulze and I am Chairman and Chief Executive Officer of Ceco Industries, headquartered in Oakbrook Terrace, Illinois. Ceco was founded in 1912 as the Concrete Engineering Company and is today the pre-eminent concrete forming contractor in the United States. Over the past several years, Ceco has been the prime concrete contractor for the Library of Congress' Madison Building, the East Wing of the National Gallery of Art, the Walter Reed Hospital, and numerous other government and private office buildings here in Washington and across the nation. We are especially proud of our role as a prime contractor for Joe Robbie Stadium in Miami, site of the 1989 Super Bowl. We are also one of the largest producers of metal buildings and a leading manufacturer of overhead and side-hinged steel doors for both the residential and commercial construction market. We currently employ over 6,000 workers across the nation, mainly concentrated in Illinois, California, Mississippi, North Carolina, Tennessee and Arkansas.

I am appearing today on behalf of the Alliance for Capital Access, a trade association of more than 100 companies that have issued or invested in high yield bonds. A list of our members is attached to my statement.

Mr. Chairman, I genuinely commend you for mounting this search for knowledge about leveraged acquisitions. But after three days of hearings I suspect your enthusiasm for the quest may have waned a bit. Thus, I will try to be brief and avoid as much as possible repeating all the shibboleths you have heard to date.

But while you have heard a great deal of testimony from government officials, academics, investment bankers, and financiers about the pros and cons of leveraged acquisitions, I believe I am the first witness to appear here who is currently running a company which has gone through a typical LBO. In that sense, I believe I offer a perspective which is different than those you have heard thus far.

Let me tell you briefly about the Ceco story.

Ceco was taken public by its founding family in 1961. Our operating company has been profitable every year since the company began, except for one year during the Depression. 1931. Between 1976 and 1985, our annual sales increased from $248 million to $613 million and our net income increased from $4.3 million to $13.1 million over the same period. Yet, because we are heavily dependent on the cyclical construction industry, Wall Street was discounting the price of our stock. In fact, even though our stock price rose from $8 in 1980 to $29 in 1985, the price continued to lag behind the actual value being created at the company; it carried a low price to earnings ratio. Wall Street was sending us a clear message: no matter how well we were running the company, no matter how well we were managing for the long term, the market believed we would fall on our faces sooner or later. Here was a classic case of a company doing all the right things and yet the stock market simply was not rewarding us for being successful, creative, long term managers.

At the same time, the descendants of Louis Meyer, the founder of the company, was seeking to sell the family's 20 percent common stock stake for estate planning purposes. Given the merger and acquisition climate in 1986, I was very concerned about the prospect of a 20 percent block of Ceco stock becoming available on the open market at one time. Bluntly, I was worried that even though we were a well-run, profitable company, we would find a hostile raider on our doorstep.

I want to emphasize something at this point: I know many of you believe that LBOs force managers to focus on short term goals at the expense of long term goals.

In our case, we did an LBO precisely because it allowed us to focus on the long term while remaining public would have forced us to meet the short-term demands of the market. And I would note for those members who are concerned about takeovers that one positive benefit from LBOs is that they free management from the short-term, quick-buck, hostile takeover pressures imposed by institutional investors and takeover artists. To the extent you force more companies to issue equity, you increase their vulnerability to the short term, takeover orientation of the public stock market.

In any event, the combination of a perpetually undervalued stock price and the desires of the family to liquify their ownership position convinced us to take the company private through a leveraged buyout in 1986. The buyout price was $41.50, a 75 percent premium over the average share price for the two years prior to the buyout. The total value of the transaction was $240 million. The management and family group invested $25 million of our own equity, or 10% of the purchase price, and the rest was financed with debt and cash assets.

Of the debt portion of the acquisition, we borrowed $113 million from our company's banks and obtained the remaining $52 million through the issuance of high yield securities in the public bond markets.

As is typical of most LBOs, the executives of Ceco, most of whom owned little or no stock in the company before the buyout, acquired a significant portion of the company's equity. That percentage will increase to approximately one quarter of the company's equity eventually through equity performance bonuses.

Let me quickly point out that this is not a case where ownership is concentrated in the hands of a small group of senior managers. Through the buyout and performance incentives, over 175 of our company's managers have a direct equity stake in ensuring the success and profitability of our business. They include not only headquarters executives, but operating unit and staff managers throughout the company.

This is one of the great virtues of LBOs and other leveraged acquisitions. Believe me, until you see it in action, you can't really imagine how powerful a tool ownership can be. By spreading ownership throughout a company, you create an extraordinary degree of entrepreneurial zeal and commitment, of teamwork, of attention to detail. It is your money that is on the line, not some faceless shareholder. That tends to focus you and your energies on building the business.

In fact, one of the most bizarre claims of anti-LBO forces is that LBO managers rape their companies. In most cases, that is pure nonsense. I challenge anyone on this panel to tell me that we have raped Ceco. We took it private because we wanted to build the business, not destroy it.

Remember, our equity is of no value if we pillage the business. The only way we succeed is if our business succeeds. All the incentives of a typical LBO are to strengthen the company, not destroy it. It is counter-intuitive to suggest that we can enrich ourselves by sacrificing the long term strength of the company. My personal fortune is tied up in this company and I will only prosper if the company grows and increases its profitability. And this is the case for virtually every LBO.

The leveraged buyout of Ceco has worked and the long-term prospects for the company are excellent. About the only party who may be unhappy are our commercial bankers and that is because we are well ahead of schedule in paying back our loan.

Our post-LBO employment is virtually identical to pre-LBO levels after adjusted for certain asset sales -- a point I will come back to. We did close two facilities after the LBO but both would have been closed anyway. The LBO accelerated what was, with or without the transaction, a rational and unavoidable business decision.

Prior to the transaction, we had initiated plans to sell some small, regional businesses that did not fit with our core construction-related businesses, much as major conglomerates were selling off divisions that did not fit into their core strategies. These are what I referred to a moment ago when I mentioned asset sales.

But this points to another issue often raised about LBOs and leveraged acquisitions -- the evil asset sale. There is a view around that an asset sale is the same as a liquidation. In most cases, it is not. We sold our divisions to people who were more intent on building them than we. The jobs were "lost" at Ceco but "created" elsewhere. As of last week, the units we sold employed more people now than when they were under our control. In other words, employment at Ceco "declined" to 5,834 workers from about 7,300. But the 1,400 "lost" employees are still working at the divisions we sold -- and their jobs are probably more secure than before.

Third, Ceco is not in an industry that relies heavily on research and development expenditures. However, the amount of money we invest in new equipment, new technologies and upgrading our construction methods is very important to our company's competitiveness and growth. And we did not cut these essential capital expenditures after our leveraged buyout. Simply put, to cut these expenditures did not, and does not, make sense. Today, we spend about the same on capital expenditures as we did prior to the LBO. And our marketing operations -- the lifeblood of the business -- have not been cutback one iota.

As I discussed earlier, the notion that LBO managers sacrifice the long term health of their company by cutting capital spending and R&D defies common sense. To do so devalues the business in which our personal wealth is tied up. True, we pay a lot more attention to where we put our research and capital spending dollars because we have less margin for waste and self-indulgent, pet projects. In this sense, LBOs promote prudent and focused use of capital and research dollars. We may spend more or less but what we spend is much more likely to increase the value of our company than when we could afford to dally with esoteric or fanciful projects which lacked a clear business rationale and return.

Further, the debt we incurred in the buyout has not hamstrung our ability to run this business. Since the LBO in 1986, we have retired over $100 million of the $165 million in debt extended to finance the LBO. We are ahead of schedule in this retirement. We retired this debt through a combination of cash from improved operations and proceeds from the sale of our non-core businesses. As a result, our interest expenses are declining rapidly.

Finally, how will we fare in a recession? In fact, the non-residential construction industry is already in a recession, and has been for the past three years. Non-residential construction orders peaked in 1985 and are down substantially since then. For example, office building awards are down 50 percent from their 1985 peak. Yet, as I have described, we are doing well. If we are what happens to an LBO company in a recession, I would say you have little to fear.

As a general rule, I believe that most leveraged companies will survive a recession if -- and this is the guts of it -- they have responsibly structured the original transaction. In our case, we built into our debt repayment model two severe recession assumptions which we used as a guide to how much debt we could safely incur and still withstand an economic downturn. It is my understanding that this is standard operating procedure. Remember, it is in the interests of the owners and managers whose fortunes are tied up in the LBO to make prudent and conservative assumptions, rather than "shoot-the-moon" ones. I will be blunt and honest: no doubt, given the popularity of these transactions, it is possible that marginal LBOs will be done. In cases where investment bankers, managers or others cut corners to chase big returns, they will find that there is no short-cut to profitability and success. But I am at a loss to suggest to you how to legislate against bad business decisions.

I would like to make a few additional observations that I believe are relevant to your inquiry.

1) A common myth is that the majority of LBOs resemble the RJR-Nabisco, Beatrice variety. In fact, according to Mergers and Acquisitions Magazine, more than 70 percent of all LBOs between 1984-88 involved an investor group taking a division or subsidiary of a public company private, not a massive public company like RJR being taken completely private by senior management and a buyout group.

Typically, these LBOs of divisions tend to be transactions of under $500 million. In evaluating whether there is, in fact, a problem which requires legislative action, I urge you to keep in mind that these LBOs do not raise many of the policy issues you are exploring, such as massive conversion of public equity into debt.

2) The vast majority of LBO activity, as demonstrated by this Mergers & Acquisitions data does not involve empire building by Wall Street financiers. The recent surge in LBO activity stems in part from the failure of the conglomerate merger wave of the sixties and seventies. Many members of Congress at the time expressed grave doubts as to the wisdom of such transactions. And they were right. Ironically, many of the same members are now expressing concern at the unwinding of the very corporate conglomerates they once criticized.

As conglomerates move "back to the basics", they have sold off divisions, individual plants and even entire companies that no longer fit their new streamlined strategies. Far from disappearing, though, many of these corporate orphans, once smothered by conglomerate parents, are thriving under new managers with a far greater commitment to growth. LBOs have empowered this new class of entrepreneurs.

3) It is also important to recognize that while much of the focus these days is on LBOs, most debt financing by business has nothing to do with LBOs. There are many companies that rely on debt financing for growth and acquisitions that have never even considered doing an LBO.

This Committee well knows that the majority of jobs in this country have been created by small and medium sized businesses. And many start-up and growth companies simply cannot or do not want to raise capital in the equity markets, either because they are too small, the markets are too volatile, or because they would have to give up control and ownership, while being forced to meet the short-term expectations of the public stock market.

While many people believe that a rollback of the interest deduction for corporate debt may discourage some LBOs, I believe that is not likely. Everything I know about business tells me that smaller firms rely proportionately far more on debt than larger ones. That is why I believe that an interest cutback will have a far reaching and damaging effect on the ability of entrepreneurs and growth companies to build their businesses. The Alliance believes that the big losers from a drop in the interest deduction would be these very companies. The big winners would be large companies, that have more financial flexibility, and foreign firms. I have noted a good deal of recent discussion over the possibility of coupling a drop in the interest deduction with new tax advantages on the equity side. As I said a moment ago, this may have appeal to some companies in the Fortune 500, but many others, especially start-up companies and growing companies, simply cannot access equity markets on the same terms as larger companies, if they can access them at all. They will feel the pain from a cut in the interest deduction and are not likely to enjoy any gain from making equity more appealing.

You can say what you want about "junk" bonds. But let me tell you from the vantage point of someone who has run a growing business: without high yield bonds, hundreds of companies would simply not have been able to grow in the past decade. These securities represent virtually the only source of fixed rate, long term capital available to growing businesses. If you make this financing more costly by limiting the interest deduction, you will be striking at the MCIs, the Compaq Computers, the Stone Containers, the Kinder-Care Learning Centers, the Harley Davidsons of this country -- everyone of which has relied on high yield bonds to fuel their growth. In our own case, at the time of the LBO, we had run a profitable company for more than seven decades and were in the Fortune 500. Despite this record of growth and profitability, we could not get an investment grade rating and would have been regarded as a "junk" company. I can assure you: there was and is nothing junky about Ceco Industries.

4) Leveraged acquisitions have played a very productive role in making American industry more competitive and productive. To my knowledge, the most comprehensive study of the effects of LBOs on businesses was carried out by Professor Steven Kaplan of the University of Chicago. After studying 69 LBOs completed between 1980-86, he found that the net effect of buyouts was to increase employment, operating income and profitability.

5) I am aware that some have asserted that the tax code is providing the impetus behind LBOs, and that the deductibility of interest makes LBOs more attractive. I can tell you that in the case of the Ceco LBO, the tax advantages of debt played no role in our decision. It was not even mentioned at any stage as we analyzed the merits of the transaction. I would also note for the record that Ceco paid taxes in 1987 and 1988, the two years following our LBO.

The truth is that most serious managers and investors are not drawn to LBOs by the tax code. Instead, the tax code influences the price that a group of managers or investors are willing to pay for a plant or division or entire company. If the advantages of debt financing currently in our tax code are curtailed, the value of that asset -- to the stock market, to its present owners, to investors and to owner/managers such as myself -- will decline.

The results of such a restriction are fairly easy to predict: a decline in the value of assets as measured on our nation's stock exchanges; lower prices being paid to current owners or shareholders when an asset is acquired; and, an inability for a group of executives, like those at Ceco, to effectively compete for control of our company with large, cash-rich conglomerates, or with foreign acquirers not impacted by our tax code.

6) With respect to the impact of leveraged acquisitions on tax revenues, once again the evidence is incomplete. But the most comprehensive study undertaken to date into the tax revenue effects of LBOs, by Michael Jensen of Harvard University, who testified before this committee yesterday, and Stephen Kaplan of the University of Chicago, found that LBOs tend to increase tax revenues, not reduce them. To quote from the study of 69 LBOs completed between 1980 and 1986, "based on the best empirical data available, LBOs appear to have at worst tax-neutral effects in present value terms and, more likely, tax-enhancing effects on the U.S. Treasury. In virtually all cases the Treasury gains substantial revenues."

In this regard, I wanted to mentioned that the study recently put out by the Joint Tax Committee on debt and equity issues was an excellent discussion of the relevant corporate finance issues. However, it paid relatively little attention to the revenue aspects of leveraged transactions. I would hope that before drawing any policy conclusions, that you will do some additional research on that point. My company and the Alliance stand ready to help in any way we can.

7) I understand the Congress is deeply concerned that leveraged acquisitions and the growth of the high yield bond market threatens our banks, our savings and loans, our pension funds, and the long term competitiveness of our country. Earlier in my testimony, I discussed

how Ceco has prepared for a recession. Here I simply want to put something in perspective for you: the annual high yield bond default rate averaged 1.22 percent between 1977 and 1987. If it went up 500 percent -- far higher that has ever been experienced -- investors who own a diversified portfolio of these securities would still earn a return commensurate with the return available from a Treasury bond. In other words, even assuming an economic calamity, high yield bonds would still be profitable. It is also worth adding that defaults don't happen overnight. Any investor in high yield bonds typically has at least six months of warning signals before an actual default, giving them ample time to sell the security and cut their losses. We have attached a fact sheet to this testimony which goes into this matter in greater detail. Also, we have attached a study of the risk adjusted returns for a wide range of S&L investments done by the Wharton Econometric Forecasting Associates. The study, the only one of its kind, shows that high yield bonds are among the most profitable investments available to thrifts. I would suggest that the same would be true if you were to examine pension fund holdings of these securities. It is simply incorrect to assert, as some do, that high yield bond investments by savings and loans and pension funds pose a threat to either depositors or retirees.

In conclusion, Ceco is a more focused and better company than ever before as a result of the LBO. And we are better positioned to manage this business for the long term and our employees jobs are safer because of that. From my own experience, I believe that Ceco is not the exception, but the rule as far as LBOs are concerned. I urge you not to take any legislative action that would restrict the ability of entrepreneurs, managers and employees to take over under-managed assets and build stronger, more competitive American businesses. Ceco and the Alliance stand ready to assist you in any way we can as you continue your study of this issue.

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HIGH YIELD BONDS AND THE NEXT RECESSION

Some observers have suggested that high yield bond defaults, which to date have been very low, will rise dramatically in the event of an economic downturn, threatening the solvency of life insurance companies, savings and loans and pension funds holding high yield bonds. Over the past several years, the high yield bond market has changed significantly -- it is much larger, more diversified over a greater number of industries and companies, and contains a significant amount of companies that have undergone LBOs over the past several years. Thus, it is fair to point out that past default experience is not a completely reliable guide to future performance.

While it is impossible to predict conclusively how high yield bond issuers and investors will fare in the next recession, the Alliance has developed some preliminary data that indicates the fears may have been overstated.

For example, preliminary research indicates that the debt-to-equity ratios of high yield bond companies today is roughly the same as the ratios of high yield bond companies in 1980. In other words, one of the most important indicators of a company's vulnerability to recessionary effects -- debt-to-equity ratios -- offers evidence that today's high yield bond issuers are generally no more leveraged than issuers a decade ago. This suggests that there is little basis to conclude that the default rate will be significantly higher simply because the market has grown.

In addition, in the 1981-1982 recession, defaults on real estate-backed loans by banks rose 40%; the default rate on commercial loans during the same period rose 42%, according to statistics compiled by the Comptroller of the Currency. The default rates on these loans have consistently been over 300% higher than high yield bond default rates in this decade.

The Alliance does not contend that high yield bonds are directly comparable investments to either real estate or commercial loans. However, comparisons with the increased default rates on these loans during the last recession can provide some guidelines to the future.

According to Morgan Stanley & Co., over the past ten years high yield bonds have returned an average of 12.38% to investors annually, net of defaults. The average annual high yield bond default rate over the same period has been 1.22%. If the high yield bond default rate were to rise 40% in the next recession, the rate would be approximately 1.70% (1.22% plus 1.22% times 40%.) Thus, the average return to investors would be reduced by 0.48%, to 11.90%, and this assumes that the defaulted bonds have no residual value. This return still represents a significant premium over the return an investor could expect from a Treasury bond, which averaged 6.11% in 1988.

Of course, we have no definite assurances that the high yield bond default rate will track the default experience of commercial and real estate loans in the next recession. In fact, high yield bond default rates could double or even triple in the next recession.

But even assuming a calamitous 500% increase in the high yield bond default rate -- higher than the most pessimistic observer would predict -- investors in this market would still match the returns experienced by holders of Treasury bonds, let alone lose money.

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SAVINGS AND LOAN INVESTMENTS IN HIGH YIELD BONDS

There has been considerable concern expressed over the past several years concerning investment by savings and loans in the high yield bond market. Critics of this investment power have contended that high yield bonds represent a particularly risky investment for thrifts, and that this power should be curtailed or eliminated.

The Alliance for Capital Access recently released a ground-breaking study conducted by the Wharton Econometric Forecasting Associates Group (WEFA) that cast serious doubt on the widely-held view that non-traditional investments by savings and loans are one of the main causes of the current thrift crisis.

The WEFA study, the first and only analysis measuring the overall returns of a wide range of thrift investments, found that investment in high yield bonds, commercial loans and credit cards provided thrifts with higher returns than traditional home mortgage lending. The study accounted for the "real world" costs to thrifts of investing in various categories, including servicing costs, matched maturity funding costs and credit risk.

Over the past five years, the study found that:

-- High yield bonds provided thrifts an average annual return (after all servicing, matched funds, and credit and interest risk costs) of 2.7%, compared with a return of only 0.3% from Treasury bonds and a 1.1% margin from fixed rate mortgages.

-- A thrift investing $10,000 in high yield bonds would have received a net return of $1,425 from that investment over the period of the study, compared to $562 from fixed rate mortgages and on $151 from Treasury bonds.

In sum, the study found that high yield bond investment powers can and do offer thrifts strong investment returns, even after default, market and interest rate risks are taken into account, This, in turn, helps thrift to fulfill their traditional home mortgage lending function -- exactly what Congress intended when it passed the Garn-St Germain Act of 1982.

Full copies of this report are available from on the Alliance upon request.

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ZENITH NATIONAL INSURANCE	**Mr. Stanley Zax**

Mr. GUARINI. Thank you very much, Mr. Schulze. Thank you for the story of Ceco.

Judith Brown, American Association of Retired Persons.

STATEMENT OF JUDITH BROWN, MEMBER, BOARD OF DIRECTORS, AMERICAN ASSOCIATION OF RETIRED PERSONS

Ms. BROWN. Good afternoon, Mr. Chairman.

The association is pleased to appear today to discuss the impact of mergers and acquisitions on retirement security. I would like to focus my remarks on two issues involving pension plans.

First, conflict of interest situations, and second, plan terminations for reversions. Pension law requires that plan trustees act prudently and solely in the interest of plan participants. This duty, however, may become clouded, particularly in takeover situations. Plan trustees, in their capacity as investment managers, must decide whether to hold or sell stock in which they have invested.

In addition, they must also vote on various proposals affecting corporate control. Plan trustees, however, often wear a second hat, that of plan sponsor or company officer. In these dual roles, they may find themselves facing a conflict of interest. Corporate or personal interest may prevent a plan trustee from acting with complete loyalty to the trust.

Large profits can and have been made from transactions in which a company is bought and resold for substantial gain. The fact that management may act as both a buyer and seller in the same transaction raises the potential for misdealing.

In light of the potential for abuse, it is essential that the fiduciary duty of loyalty be affirmed. Plan trustees must act solely in the interest of plan participants, and should avoid placing themselves in a position where their dual roles will prevent them from functioning with complete loyalty to the trust.

Therefore, where the potential for conflict exists, plan officials should seek independent, disinterested advice or temporarily step aside from the management of the trust.

A second major concern for pension security is pension terminations for reversions. As employers find themselves in need of ready cash, whether for fighting takeovers or retiring large amounts of debt, it is often employee benefits that are the source of needed funds.

In particular, the build-up of pension assets in defined benefit plans have been a recent target. These plans tend to fund benefits in the early years in order to meet future benefit obligations. This prefunding, coupled with better than expected returns on plan funds, has led to a large build-up in pension assets estimated at about $200 billion more than is currently needed to satisfy benefit obligations.

These assets, not removable from an ongoing plan, can be recaptured by terminating the plan. This ready source of cash, called a "reversion," has become an attractive target. Since 1980, 2,000 plans have been terminated for reversions over $1 million each, totaling $20 billion in recaptured funds. AARP believes a significant portion of these assets have played a major role in mergers and acquisitions.

Preliminary information from a recent 3-year span indicates that about two-thirds of companies with large reversions—over $50 million—have also been engaged in mergers and acquisitions. The total amount of pension reversions for those companies equaled over $3 billion. AARP believes that terminations for reversions are harmful to the economic security of current and future retirees. The association has long urged restrictions on reversions and has pointed to their use in takeovers as particularly undesirable diversions of retirement funds.

AARP recommends, among other options, that reversions should be discouraged by requiring a sharing of reversion assets with employees and retirees and prohibiting asset reversions in takeover activity.

To conclude, AARP believes the recent wave of mergers and acquisitions has had a detrimental impact on benefit security. We hope to continue to work with this committee to pursue actions that will better insure retirement security. Thank you.

[The statement of Ms. Brown follows:]

STATEMENT OF JUDITH BROWN, AMERICAN ASSOCIATION OF RETIRED PERSONS

The American Association of Retired Persons (AARP) appreciates the opportunity to express its views on the recent wave of mergers and acquisitions and the accompanying involvement of, and effects on, pension plans. They Association believes the explosion of activity in this area, and the often adverse consequences for pension plan participants, is cause for great policy concern.

Background

The Employee Retirement Income Security Act (ERISA) was intended to protect the rights of participants and their beneficiaries under private pension, health and welfare plans. ERISA sets certain minimum standards for the protection of plan participants, particularly in the areas of vesting, participation, and funding. In addition, ERISA establishes a strict standard of conduct for plan fiduciaries -- those who have been empowered to administer and manage the assets in a plan. ERISA requires that a plan fiduciary act "prudently" and "solely in the interest of plan participants and their beneficiaries."

According to recent Department of Labor estimates, pension funds contain approximately two trillion dollars in plan assets. Other studies estimate that pension plans hold approximately 17% of all corporate stock and 7.5% of taxable bonds traded in the financial markets.

In addition, pension plans contain roughly $200 billion more than is needed to pay pension obligations currently owed to plan participants. While this so-called pension "excess" is not currently owed, much of the pre-funded amounts are intended to meet the future needs of current workers' pension expectations. However, since 1980, about 2000 healthy defined benefit plans have been terminated, with nearly $20 billion returned to plan sponsors.

Overview of Problem

Many believe that the recent surge of leveraged buy-outs (LBO's) and the accompanying increase in indebtedness has put companies at a greater risk of collapse should the U.S. economy, or critical sectors, take a downward turn. Many of the firms that have been the targets of LBO's are major corporations. While a recession would of course put tremendous pressure on the entire economy, those dependent on these corporations would be particularly hard hit.

To a large extent, pension plans themselves have invested in takeover attempts. While these investments have often proved profitable, a conflict of interest may arise when pension trustees are also officers of the company. In this dual role, pension trustees may have interests other than the interests of plan participants, resulting in plan action not solely in the best interests of plan participants.

LBO's have often resulted in sold-off and closed-down plants or divisions, accompanied in many instances by terminated pension and retiree health plans, and other reductions in employee and retiree benefits. In effect, LBO's -- which have meant quick profits to the bankers, lawyers, and corporate managers -- have often been at the expense of taxpayers, employees, and retirees.

Pension Plans as Investors

In general, corporate takeovers involve changes in ownership or control of corporate assets. Because of the large amount of assets in pension plans, including significant stock and bond holdings, plan fiduciaries may become involved in corporate takeovers in two ways: first, as investors of plan funds, and second, as fiduciaries who vote stock held by the plan.

During takeovers, pension plan fiduciaries, in their capacity as investment managers, must decide whether to hold or sell stock in which they have invested. In addition, they must also vote on various proposals affecting corporate control, including anti-takeover measures.

In recent years, pension plan assets have been increasingly invested in high-risk, high-yield bonds ("junk bonds"), often used to help finance takeover activity. One estimate has pension funds owning approximately 15 percent of the outstanding junk bonds, second only to insurance companies. Additionally, pension plans have committed to loan money to investors engaged in takeover activity and have invested in "pooled funds" whose specific purpose is to provide liquidity to engage in leveraged buyouts. In particular, some public pension funds have been among the largest investors in these transactions. These funds have contributed in part to the recent unprecedented liquidity in the market, which has prompted even larger deals.

Critics have already detailed the potential menace of the "leveraging" of corporate America. To the extent that the heavy use of debt threatens the financial system and the investments made on behalf of pension plan participants, the potential for economic loss during a recession or economic slowdown is greatly magnified.

Pension plan involvement in takeover activity raises several concerns regarding risk and benefit security of plan participants. While ERISA places certain restrictions on risk investments for private pension plans, other plans, such as public plans, may need additional standards. In any event, the question of whether tax-favored pension funds should continue to help fuel LBO's is an issue that should be addressed within the broader context of problems associated with a high degree of leveraging.

Potential for Conflict-of-Interest

Aside from the economic implications of favoring debt over equity, pension plan fiduciaries have an even greater responsibility to plan participants for investment decisions. In certain transactions, this duty may be clouded by other interests. In particular, plan fiduciaries in merger and takeover situations may face conflicts-of-interest when choosing between their roles as plan sponsors and their roles as guardians of the interests of plan participants and their beneficiaries.

For example, when a corporation is threatened with a takeover bid, a plan fiduciary must make decisions on the voting or selling of corporate stock, keeping in mind the "sole" interests of plan participants. However, when this fiduciary is also an officer of the corporation sponsoring the plan, the decision may inevitably be overshadowed by personal concern for one's continued employment or financial status in any new company. Fairness to plan participants in plan dealings is thus called into question.

The recent trend towards larger and larger mega-deals magnifies the fairness issue. The fact that management acts as both buyer and seller in the same transaction naturally raises the potential for misdealing. Large profits can be and have been made from transactions in which a company is bought and resold for substantial gains. In particular, these deals raise strong questions regarding fairness in the valuation of the initial purchase price.

Examples of Fiduciary Conflict-of-Interest

Fiduciary conflict-of-interest can be demonstrated through any number of examples. In one case, plan administrators had invested the plan's assets in the stock of corporations in which they were trying to gain control. In this instance, while both the plan and the administrators profited from the investments, an investigation ensued. The Department of Labor, in an amicus brief, stated that during a takeover struggle, a fiduciary should resign and a neutral trustee be appointed to manage the trust's assets. The court, while agreeing that this action was advisable, stated it was not required, but determined that in any event the plan administrators had not acted in the sole interests of plan participants. The court properly concluded that the plan administrators had violated their fiduciary obligations by investing plan assets to further their own interests.

In a current case illustrating divided loyalties for fiduciaries, the trustees of a profit-sharing plan induced plan members to sell back to the company their shares of company stock held in the plan. At the same time, the trustees, who were also company officers, were engaged in discussions concerning several potential hostile purchasers. The aggressive stock repurchase program was targeted at employees age 55 and older. The trustees: (1) failed to inform these employees of the potential takeover bids; (2) failed to inform the employees of prior company action to purchase stock at prices above those quoted on the New York Stock Exchange; and (3) failed to inform the plan participants that the "break up" value of the stock had recently been estimated at a value significantly higher than that offered in the repurchase program. The stock repurchased by the Company from its employees was resold six months later after the takeover was completed at a price nearly 50% higher.

This case, currently before the courts, illustrates again the potential for harm to plan participants from trustees wearing two hats -- that of plan fiduciary and that of company officer. In their role as company officers, the trustees had reason to want company ownership of outstanding stock to help fight off, or negotiate, a takeover. In this capacity, the trustees also had access to information necessary to informed decision-making by plan participants. This information was not shared with plan participants, and indeed the trustees arguably counseled plan participants to act against their best interests merely to serve the interests of the company officers. In these instances, plan trustees are in a position where they may not act solely for the benefit of plan participants.

Recommendations

In light of the potential for abuse in the inevitable circumstances of conflict-of-interest, it is important that the fiduciary duty of loyalty be reaffirmed in order to insure that plan participants are not harmed. Plan trustees must act solely in the interests of plan participants and their beneficiaries, and must avoid placing themselves in a position where their dual role as officers of the corporation will prevent them from functioning with complete loyalty to the trust.

In short, where the potential for conflict and misuse of plan assets arises, plan officials should seek independent, disinterested advice. The fiduciary should therefore be required to either resign or temporarily step aside from the management of the assets of the trust. In addition, better clarification of fiduciary responsibilities, including voting procedures and disclosure policies, is necessary to insure the rights of plan participants.

Short-Term Cash Needs -- A Threat to Benefit Security

A second major concern of employees and retirees is the effect of increased merger and acquisition activity on benefit security. In particular, as employers find themselves in need of ready cash -- whether for fighting takeovers or retiring large amounts of long-term debt -- it is often employee benefits that are the source of needed money.

Termination of Pension Plans to Gain Access to Plan Funds

One source of ready cash that has been exploited in recent years is money in defined benefit pension plans. Under current law, a company cannot withdraw assets from a pension fund. However, the law allows a company to completely terminate a pension plan, pay benefits that were earned up to the date of plan termination, and recapture any assets that remain in the pension trust. There are no restrictions on the employer's use of these assets (although a 15 percent excise tax applies).

In general, these defined benefit plans are plans that promise a specific pension benefit upon retirement. The benefit amount is usually based on a formula involving number of years of service and salary. Because of this formulation, these plans tend to accrue benefits more rapidly in the later years of an individual's work life. In order to account properly for the build-up in pension benefits in the later years, companies generally are required to prefund their pension benefits in the early years.

This prefunding, coupled with better than expected returns on investment of plan funds, has led to a large build-up in pension funds beyond what is currently needed to satisfy the accrued benefits of plan participants. A recent study of Fortune 500 companies (using 1987 financial statements) indicated that 86% of companies had assets in excess of their accrued pension benefit obligations. While these funds will for the most part be needed in on-going plans to meet future benefit obligations, they are considered "excess" on a current plan termination basis. In total, it has been estimated that the amount of pension fund "excess" on a plan termination basis is about $200 billion.

Since these assets are a ready source of cash, the build-up of assets in defined benefit plans has become an attractive target. For example, Company A may take over Company B, then terminate Company B's pension plan, removing any pension funds not needed to pay plan benefits earned up to that date. These recaptured funds may then be used to help finance (i.e., pay off corporate debt) the original takeover. On the other hand, Company B, realizing it is the target of a takeover, may prematurely terminate its own plan in order to gain access to cash to help it fend off a takeover bid. Company B's termination of its own plan may also make it a less attractive takeover target.

Scope of Problem of Terminations for Reversions

The scope of pension terminations for reversions in this decade is alarming. Terminations for reversions were essentially unknown before 1980. Since that time, and as of September 30, 1988, (according to Pension Benefit Guarantee Corporation (PBGC) information), nearly 2000 plan terminations with reversions of over $1 million each have been completed. The total amount of recaptured pension assets has now reached nearly $20 billion, and the number of plan participants affected by these terminations has reached nearly 2 million.

The General Accounting Office noted in a 1986 report that

Congressional oversight was warranted because "many employers were terminating plans with excess assets because of a desire to use the excess assets for non-pension-related purposes, such as alleviating adverse business conditions or retiring long-term debt."

While legislative efforts to curb this abuse have made modest progress in the past few years, the threat to employee and retiree benefit security remains high. Generally, whether an employer establishes a new pension plan (and what type of plan) determines the extent employees are made worse off. Again, PBGC data on pending pension terminations as of September 30, 1988, is instructive. According to the PBGC, one-quarter of plan participants are in plans that have not established a new plan. In addition, one-half of plan participants are in plans which have created new defined contribution plans, plans in which investment risk falls on the employee. Only one quarter of participants are in plans in which the employee is generally best protected -- a reestablished defined benefit plan. (Even in these instances, the plan is bound to be far less well funded, since the "cushion" of assets that had been built up has now been stripped by the termination.)

In these terminations, annuities are generally bought to cover retirees' benefits. The practical result is that retirees are unlikely to receive any future pension adjustments. This contrasts with the latest Department of Labor information that suggests that nearly 40% of retirees have received some type of ad hoc pension adjustment to compensate for the loss of value in pension amounts over time.

While the incidence of reversions has declined from its peak in 1985, AARP believes the threat of terminations for reversions remains a serious problem. First, a number of companies have already taken reversions, suggesting that the decline is temporary because many have recently taken their "first bite" of the pension apple. Second, interest rates are increasing, which makes annuities cheaper to purchase, leaving more reversion assets in a plan termination. Third, Congressional action in the past few years has most likely inhibited some reversion activity. This includes various proposed restrictions which have not been enacted, but have likely caused uncertainty. (A Treasury Department letter from October 22 of last year, set to expire on May 1 of this year, has put a temporary halt on granting termination letters for reversions.)

In addition, the Association believes that pension plan assets will continue to play a significant role in mergers and acquisitions. To the extent that the markets and corporate managers are preoccupied with cash flow, pension assets will remain a target.

Role of Reversions in Mergers and Acquisitions

To underscore the role that pension assets have played in mergers and acquisitions, it is instructive to review the activity that has taken place thus far. Using PBGC lists of companies that have completed terminations for reversions, and comparing them with companies that have been involved in merger and acquisition activity, suggests the extent of pension money involvement in these transactions. While it is difficult to trace the exact use of money recaptured from pension funds, the cross-match of companies highlights the current threat to participant's pension security.

Preliminary figures indicate a strong correlation between companies with terminations for reversions and those involved in mergers and acquisitions, particularly where large pension reversions are involved. For the companies with the largest pension reversions (over $50 million recaptured by the employer) between January 1, 1986 and September 30, 1988, about 65% (11 of 17) had also been involved in merger and acquisition activity. The total amount of pension reversions in this time period for these companies equals about $3 billion. No doubt a portion of these recaptured pension funds played a significant role in non-pension related actions.

Recommendations

AARP continues to believe that terminations for reversions are harmful to the economic security of current and future retirees. The Association has long urged restrictions on terminations for reversions, and has pointed to their use in takeovers and acquisitions as particularly undesirable diversions of retirement funds for non-retirement purposes, and often for activities of questionable economic value. The Association has supported policies to discourage terminations for reversions and to provide protections for employees and retirees. This includes a "sharing" of reversion assets with employees and retirees, as well as higher excise taxes on reversions to employers. A prohibition on asset reversions in takeover activity should also be considered.

Additional Harm to Employees and Retirees

While there exists some information as to the impact of mergers and acquisitions on pension security, there is even less information on other important aspects of employee and retiree security. Since leveraging requires the need for assets to retire debt, a company may be forced to cut back on benefits it might otherwise have maintained. For example, a number of corporate restructurings have also included the elimination or modification of important benefits such as retiree health benefits. These benefits are not currently guaranteed by federal law, although some courts have upheld retirees' rights to these benefits on a contractual basis. However, in the event the employer must divert cash to short-term needs, reducing funds for non-protected benefits such as retiree health benefits are another means to improve the short-term bottom line.

Other forms of economic dislocation may also be occurring, but they are again difficult to quantify. Many argue that plant-closings and large-scale layoffs are attributable to corporate need to generate greater cash flow to service debt. Such changes not only directly affect the individuals involved, but have repercussions in the community at large.

Conclusion

In conclusion, the Association believes the recent expansion of mergers and acquisitions, and increased corporate leveraging, has had a detrimental impact on benefit security. Some of the problems are a direct result of this activity, while other issues are broader problems that are exacerbated in the context of corporate takeovers.

As Congress addresses the broader questions of corporate debt and leveraging, it is also necessary to look at the component parts to better understand economic dislocation and the accompanying effect on individuals. AARP hopes to continue working with this committee to highlight problems, leading ultimately to action that will better ensure retirement income security.

Mr. Guarini. Thank you very much.

Richard Mendelson, Employee Stock Ownership Association.

STATEMENT OF RICHARD D. MENDELSON, PRESIDENT, EMPLOYEE STOCK OWNERSHIP ASSOCIATION, AND PRESIDENT, KATZ COMMUNICATIONS

Mr. Mendelson. Good afternoon. My name is Richard Mendelson. I am the president of Katz Communications, 1 Dag Hammarskjold Plaza in New York City. I am also president of the Employee Stock Ownership Association, also known as the ESOP Association, headquartered in Washington, DC.

I testify for the approximately 1,500 ESOP Association members. Mr. Chairman, the data I am giving on leveraged ESOP's compared to all corporate debt transactions is contained in more detail in this particular notebook. We don't ask that this notebook be included in the committee record, but that you take it and keep it in the committee files so that you, your colleagues and staff may review it as you wish.

Leveraged ESOP's are few in number and value when compared to non-ESOP LBO's and other corporate debt transactions. I call your attention to graph No. 1 to my right. The red lines represent all LBO's. The blue lines represent ESOP LBO's. We define an ESOP LBO as one which results in the ESOP holding 50 percent or more of the corporation's equity. The graph shows ESOP LBO's number 3 to 8 or 9 per year, usually around $1 to $2 billion in total value in comparison to the hundreds of conventional LBO's that are worth, many, many billions. Please note we did not include the RJR LBO in the 1988 red line or it would have gone way off the top of the chart. Percentagewise, the number and value of the ESOP LBO's compared to all LBO's are 2 to 4 percent on the average. The value is highest in 1987 because of two large ESOP transactions, Health Trust and Avis.

Because your interest goes beyond LBO's, graph No. 2 compares all leverage ESOP's over $1 million in value to all conventional corporate debt transactions. Again, ESOP's are blue, non-ESOP debt is red. The blue line is estimated because data on leverage ESOP's are hard to come by. We are pleased to say our numbers tend to conform to related IRS data. The percentage of leverage ESOP's is small, 1 percent to 3 percent on the average. From graph 2, you can see that the absolute number in dollar value of leveraged ESOP's increased to a modest degree after debt for leveraged ESOP incentives post-1984 and after TRA ESOP incentives post-1986 became law. On a percentage basis, the number and value of ESOP LBO's compared to all LBO's have not changed to any significant degree in the past 5 years in spite of the incentives. Clearly, Mr. Chairman, these facts on leveraged ESOP's prove we are, unfortunately in our view, a very small part of the world of corporate financing.

We think the facts are unfortunate because leveraged ESOP's serve to break the concentration of wealth caused by conventional corporate debt financing such as non-ESOP LBO's. Leveraged ESOP's must meet significantly more stringent government regulations than conventional corporate debt financing, specifically the high fiduciary standards of ERISA, including valuation concepts. Leveraged ESOP's are equity oriented transactions because each dollar of ESOP debt leverage paid results in a dollar of employee equity. If the committee wants to know who the large leveraged ESOP's are, they are listed in our notebook. If you wish to learn firsthand about what these ESOP companies are about and how their employee owners are faring, we say go see them firsthand or ask them to come visit with you or please come to our annual May convention held each year in this city. Most of these companies will have employees there. ESOP companies are proud of their ESOP and their employee owners welcome a chance to talk about their company. ESOP companies and employees are not appreciated until you see them in action. For example, the story of my company, Katz Communications, and its ESOP is not appreciated until the facts are understood.

Katz is over 100 years old and has a 16-year-old ESOP. We are an advertising sales representative firm representing radio and TV stations nationwide. We are the largest representative firm in the industry, representing nearly 200 television and well over 1,000 radio stations. We are 100 percent owned by our ESOP. Every employee is in our ESOP. In 1972, a man named Emmanuel Katz no longer wanted to own and manage Katz Communication. Katz then converted its profit sharing plan into an ESOP in 1972 to buy the company from the Katz family. We note with pride that this is pre-ERISA and we are the eighth qualified ESOP in the nation.

In the beginning in 1972, the Katz ESOP purchased 49 percent of the Katz family shares and 20 company executives bought the other 51 percent. In 1978, we decided to value our ESOP stock based on an independent appraisal, not only book value. Our latest independent appraisal was $17.50 per share. Initially in 1978, it was $4 a share. This increased appreciation has gone into our employees' pockets when they have or will retire or leave Katz with vested accounts. In 1982, Katz sold $10 million of newly issued stock to the ESOP and used the $10 million and some borrowed money to purchase four radio stations.

The radio station investment went well. The four stations grew to 11 stations, which were acquired through debt. As our sales representative business grew, our radio station, a $54 million investment, grew as well. By 1986, many Katz employees had very large account balances in their ESOP's.

One-half to $1 million was not uncommon. The radio broadcast investment had doubled in value. In 1986, 66 percent of the Katz stock was in the ESOP and 33 percent was owned by 200 employees. We then saw a problem emerging because of our success. In a year or two, we would face a discount in our stock because its value would grow beyond our ability to buy it from retiring or departing employees. We were told to go public or sell our successful company.

We knew that no purchaser would allow our ESOP to have all of the profits as was occurring to the delight of our employees. A new owner would want our cash-flow to retire his acquisition debt and might substantially reduce our service oriented work force. We created a two step solution to our dilemma. First, the employees of the radio station group arranged a $68 million leveraged buyout of

Katz Broadcasting, their own division. This $68 million solved our repurchase liability on behalf of our employees. In step two we leveraged our ESOP to buy the non-ESOP shares from the 200 key employees. The amount was $30 million. We utilized code section 133, ESOP lender interest payments on this $30 million. We are retiring this $30 million debt over a 5-year period. This is very important. As the loan is repaid from contributed profits, all employees receive the shares. Has the Katz ESOP enriched Katz employees from the top to the bottom? The answer is a resounding yes. We say at Katz that we don't give a retiring employee a gold watch. Our employees might buy the jewelry store. Again, we are referring to benefits in the hundreds of thousands of dollars for employees whose wages may never have gone over $25,000 a year.

Once one of our employees applied for a mortgage from one of the big New York banks. This fellow worked in the mail room. He listed an ESOP account worth several hundred thousand dollars on his loan application. The loan officer called me, convinced the employee had overstated his worth. I checked the man's account balance, and he had actually understated his ESOP account by about $50,000. I told the bank officer. The next week I received a letter marked personal addressed to me. It was from the loan officer. He wanted to leave his bank job and come to work for Katz where he could make some real money. At Katz, ESOP is not a corporate policy. ESOP is our corporate religion. We, and I speak for the whole ESOP community, believe that real ownership is gaining your stakehold, holding it, working with it and nurturing it until it grows into a steady tree. We turn energy into equity. We don't believe stock ownership means buying and selling our employers stock for short-term profiting. We believe this quick-buck frame of reference is probably why you are having these hearings on LBO's. We are not part of the world of fast buck financiers and stock market roulette. We are focused on solid business in the long term. We are dedicated to providing capital wealth to all employees, not a chosen few. Thanks for bearing with me. With that, I conclude.

Mr. GUARINI. Thank you.

[The prepared statement follows:]

STATEMENT OF RICHARD MENDELSON
PRESIDENT OF KATZ COMMUNICATIONS

Mr. Chairman, my name is Richard Mendelson. I am the President of Katz Communications, 1 Dag Hammarskjold Plaza, New York, New York.

I am also President of the Employee Stock Ownership Association, also known as the ESOP Association, headquartered here in Washington, D.C. at 1100 Seventeenth Street, Suite 310. I testify for the approximately 900 ESOP Association ESOP company members and the approximately 500 associate, educational, and international members.

The most important thing for the Committee to know about leveraged ESOPs in the context of corporate debt is to know -- "How many leveraged ESOPs are there and what is their debt compared to all corporate debt?" And finally, "Who are the ESOP companies, and how are they doing?"

Mr. Chairman, all the data I give is set forth in the notebook I hold in my hand. We do not ask that the notebook be printed in your Committee record, but that you accept this notebook, and place it in the Committee files so that you, your colleagues and your staff may review it in more detail.

In our data we discuss ESOP LBO's, and large leveraged ESOPs. We distinguish ESOP LBO's from large leveraged ESOPs as follows: An ESOP LBO is when the ESOP holds 50% or more of the equity of a corporation after the ESOP acquires the stock whereas a large leveraged ESOP is one where the ESOP holds less than 50% of the corporation's stock, but is valued at more than, generally, $10 million.

Our data on LBO'S and corporate debt in general is from the magazine Mergers and Acquisitions. Our data on leveraged ESOPs is from the National Center for Employee Ownership, a non-profit research organization based in Oakland, California. It is not affiliated in any way with the ESOP Association. We at the ESOP Association did use our own files to calculate an estimate for all leveraged ESOPs of more than $1 million in value. We are proud to say that our data is in line with data we see published by the IRS on ESOPs.

In 1988, LBO transactions worth approximately $41 billion occurred. (This $41 billion does not include the $25 billion RJR LBO.) This $41 billion represents approximately 225 LBO transactions. Of the 225 LBOs in 1988, 8 were ESOP LBO's, or 4% of the total number. These 8 ESOP LBO's were valued at $1.8 billion, or 4% of the total $41 billion value of 1988 LBO transactions.

In 1987, there were 267 LBO transactions worth approximately $36 billion. 1987 was the record year for the value of ESOP LBO's, and that value was approximately $3.8 billion, of which two transactions (Healthtrust and Avis) accounted for $3.5 billion, or 92% of the ESOP LBO value. In this record year for ESOP LBO's, therefore, ESOP LBO's accounted for 10.5% of the total LBO transactional value. In terms of the number of ESOP LBO's compared to all LBO's, there were 7 ESOP LBO's, or 2.6% of all LBO transactions.

In 1985, the first full year after Congress enacted special incentives for leveraged ESOPs, there were 5 ESOP LBO's out of a total number of 254 LBO transactions, or 2% of the total. The 5 ESOP LBO's had a value of $848 million, or 4% of the total LBO transactional value of $19.6 billion.

In 1983, prior to the special leveraged ESOP tax incentives, there were 3 ESOP LBO's valued at $302 million compared to 230 LBO transactions valued at $4.5 billion. So the number of ESOP's was 1% of the total, and represented 7% of the total LBO value.

Correlating these numbers, our graph No. 1 shows the relationship of all LBO's, the red lines, to ESOP LBO's, the blue lines. Attached to my statement are copies of this graph and another I will show later.

It is harder to validate statistically the LBO transactions involving corporations valued between $1 million to $50 million. With the caveat that there is no statistical verification of the following statement, the ESOP Association believes the percentage of LBO's involving ESOPs in this group of smaller LBO transactions is the same as the percentage in the larger, well-known LBO transactions.

The sum of the information is that leveraged ESOPs account for only a small part of the debt associated with LBO's, approximately 2 to 3% of the number of LBO's, and 5 to 7% of the value.

Because the Committee's concern extends beyond LBO's to all corporate debt transactions, we have compiled data on all leveraged ESOPs, not just ESOP LBO's.

Thus, we have combined on Graph 2 leveraged ESOPs that do not acquire at least 50% of the corporation's stock with the ESOP LBO data.

Just as the ESOP LBO represents a small percentage of all LBO's, leveraged ESOPs represent a small percentage of all corporate debt transactions.

There were approximately 112 leveraged ESOP transactions worth over $1 million in 1988 at a value of approximately $4.3 billion. This number includes the ESOP LBO's.

This compares to approximately 2800 corporate transactions worth $205 billion. These numbers do not include the $25 billion RJR LBO but do include the completed 1988 LBO's.

Thus in 1988, of all corporate transactions, only 4% involved ESOPs, and these 4% of the transactions represented 2% of the value of all corporate transactions.

In 1987, leveraged ESOPs were in 2% of the transactions, and represented 3% of the value.

Since Congress enacted incentives for leveraged ESOPs in 1984, these 2% to 4% numbers are consistent.

Since 1982, we estimate that leveraged ESOPs were part of only 1.6% of all corporate debt transaction over $1 million value.

In fact, on graph 2 the scale is not accurate. The red lines representing all corporate debt transactions, should be 12 inches higher, and the blue lines, representing ESOPs should be on the bottom axis line.

So, from graph 2, you can see that the absolute number and dollar value of leveraged ESOPs increased to a modest degree after the DEFRA leveraged ESOP incentives (post-1984), and after TRA ESOP incentives (post-1986) became law. On a percentage basis, however, the number and value of ESOP LBO's compared to all LBO's have not changed to any significant degree in the past 5 years, in spite of the incentives.

Clearly, Mr. Chairman, these facts on leveraged ESOPs prove we are a very small part of the world of corporate financing.

We think these facts are unfortunate because

1. Leveraged ESOPs do serve to break the concentration of wealth caused by conventional corporate debt financing such as non-ESOP LBO's;

2. Leveraged ESOPs must meet significantly more stringent government regulations than conventional corporate debt financing, specifically the high fiduciary standards of ERISA, including valuation concepts; and

3. Leveraged ESOPs are equity-oriented transactions because each dollar of ESOP debt leverage repaid results in a dollar of employee equity.

In fact, the ESOP Association, in accord with the economic theories of Dr. Louis O. Kelso, endorse the deductibility of all corporate dividends. Currently, dividends on ESOP stock is deductable under Code Section 404(k), and we would welcome this approach for all dividends as the solution to the preference for debt over equity.

If the Committee wants to know who the large leveraged ESOP companies are, they are listed in our notebook. If you wish to learn first-hand about what these ESOP companies are about and how their employee owners are faring, we say go see them first-hand, or ask them to come and see you. Or, come to our annual May convention held each year in this city. Most of these companies will have employees there. Our experience is that ESOP companies are proud of their ESOP, and as employee owners welcome the chance to talk about their company.

ESOP companies and employees are not appreciated until you see them in action. Macro data, pension experts, professors, lobbyists, and tax experts do not, and cannot educate anyone about the dynamics of employee ownership and ESOPs.

For example, the story of KATZ Communication and its ESOP is not appreciated until the facts about KATZ are understood.

KATZ is over 100 years old with a sixteen year old ESOP.

We provide a sales and marketing service selling spot advertising time on TV and radio throughout the United States. Our income is derived from commissions earned on sales, pursuant to a contract between the station and KATZ, wherein KATZ is recognized as the station's exclusive national sales representative.

We are the largest representative firm in the industry, in billing, in number of clients, in number of offices, and number of employees.

Our corporate management section is very small, and nearly all of our approximately 1400 employees are in operations.

We are 100% owned by our ESOP.

To give you history on how we became an ESOP, let me start at the beginning. Emanuel Katz, who had become a key employee of the Hearst San Francisco Chronicle and Examiner, came to New York City in 1887 where he became a news gatherer and ad manager for the New York Journal. He then pioneered the idea of selling newspaper ads to advertisers located outside of the local market area. In 1888, Katz left Hearst to open his own firm: The E. Katz Special Advertising Agency.

Expanding and growing with the development of radio and TV, KATZ moved into the advertising rep business nationwide in radio and TV, and moved away from newspapers in 1969.

In 1972, the third and fourth generation of Emanuel Katz no longer wanted to own and manage KATZ Communications.

KATZ then converted its profit-sharing plan to an ESOP in 1972 to buy the company from the KATZ family. We note with pride that this was pre-ERISA, and we were the first U.S. communications company to take advantage of the ESOP concept. We are the 8th qualified ESOP in the entire nation.

Because we sense that many wonder what will be the experience of the hundreds of leveraged ESOP companies formed since 1982 over the next 15 to 20 years, we expose you to KATZ to glance at what the future may be for new ESOP companies.

Our 16 year experience tells us that the future looks very good with great financial rewards for the employees.

In the beginning, 1972, the KATZ ESOP purchased 49% of the KATZ family shares, and 20 company executives bought the other 51%.

From 1972 through 1977, the ESOP continued to operate as a profit sharing plan with the following attributes:

a. Cash, not stock, was contributed to the trust;

b. ESOP accounts were paid out in cash;

c. Company stock was valued at book; and

d. Katz had fewer than 500 employees.

In 1978, we decided to value our ESOP stock based on an independent appraisal, not on book value.

In 1978, not only did we switch to an independently appraised value, but also split the stock 10 for 1 before we did so.

The initial per share value in 1978 was $4.00 per share.

Our latest independent valuation was $17.50 per share. This increased appreciation has gone and will go into our employees' pockets when they retire, or leave KATZ with vested accounts.

Not only did we pioneer the independent appraisal for our stock in 1978, but we also pioneered buying the stock from departing employees with cash and limiting ownership to current KATZ employees.

After 1978, contributions by the company to the ESOP rose as the company consistently paid in 15% of covered payroll - and our payroll increased as the company grew. As the company's shares rose in value, so did the ESOP, which then owned 49% of the shares.

In 1982, KATZ sold $10 million of newly issued stock to the ESOP and used the $10 million and some borrowed money to purchase four radio stations.

The radio investment was a good one and the four stations grew to eleven stations, which were acquired through debt. Meanwhile as our sales rep business grew and flourished, our radio business grew to a $34 million investment; and by 1986, many KATZ employees had very large account balances in their ESOPs -- $1/2 to $1 million.

And by 1986, 66% of the KATZ stock was in the ESOP, and 33% was owned by 200 employees.

We then saw a problem emerging because of our success. In a year or two, we would, regardless of our success, face a discount in our stock because its value was beyond our ability to buy it from retiring and departing employees.

We were told to go public, or sell our successful company.

We knew that no purchaser would allow our ESOP to have all of the profits, as was occurring to the delight of our employees. A new owner would want some of our cash flow to retire his acquisition debt, and might substantially reduce our service-oriented work force.

The solution came when the management of the radio broadcast group arranged a $68 million leveraged buyout of KATZ Broadcasting. This $68 million solved our ESOP repurchase liability to our employees, but this was only step one. In step 2, we leveraged our ESOP to buy the non-ESOP shares from the 200 key employees. The amount was $30 million. We utilized the Code Section 133 ESOP lender interest payments on this $30 million loan. We will retire this $30 million debt in 5 years. So we are now a 100% ESOP company with no need to sell or dilute our profitable enterprise.

Has the KATZ ESOP enriched KATZ employees -- from the top to the bottom?

The answer is a resounding yes.

We say at KATZ that we do not give a retiring employee a gold watch, we give a check large enough so that the employee may buy the jewelry store.

Again, we are referring to benefits in the hundreds of thousands of dollars for employees whose wages may never have gone over $25,000 per year.

Once, one of our employees applied for a mortgage from one of the big New York City banks. He worked in the mail room. He listed an ESOP account worth several hundred thousand dollars on his loan application. The loan officer called me, convinced our employee had lied. I checked the man's account balance, and he had actually understated his ESOP account by about $50,000. I so told the bank officer. The next week, I received a letter, marked personal, addressed to me from this big New York bank. It was from the loan officer. He wanted to leave his bank job and come to work for KATZ, where he could make some real money.

Yes, at KATZ, ESOP is not corporate policy; ESOP is our corporate religion.

To conclude, we at KATZ bristle when we hear the baseless charges against ESOPs as "bad" retirement plans; or not "real" ownership.

The ESOP Association testified to your Oversight Subcommittee on September 6, 1985, that, if you define retirement income security as a little bit a month during someone's post-working years, then the ESOP is not a retirement plan.

But in our view, income security means having money, and since our ESOP pays a large amount of money to KATZ employees when they retire, we are providing better retirement income security than any other ERISA plan I know of, unless some of our other ESOP companies, who have testified to you before, are paying out even more.

We, and I speak for the whole ESOP community, believe that real ownership is taking your stakehold, holding it, working with it, and nurturing it until it grows into a sturdy tree.

We do not believe stock ownership means buying and selling your employer's stock for short-term profiteering. We believe this short-term view, this go for the quick-buck frame-of-reference is probably why you are having these hearings on LBO'a and takeover artists.

We are not part of the world of fast-buck artists and stock market roulette. We are focused on the long-term, and we are focused on providing capital wealth to all employees, not to a chosen few.

With that, I conclude.

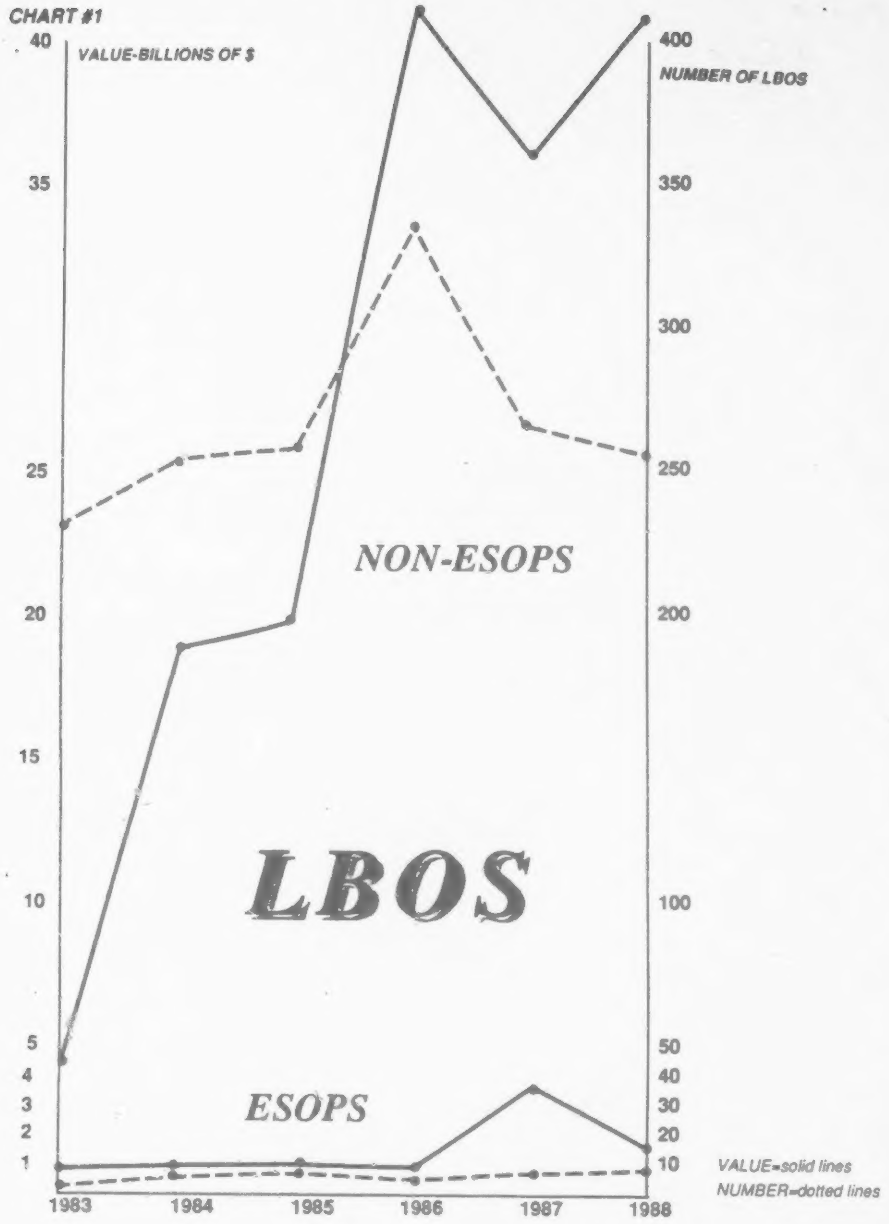
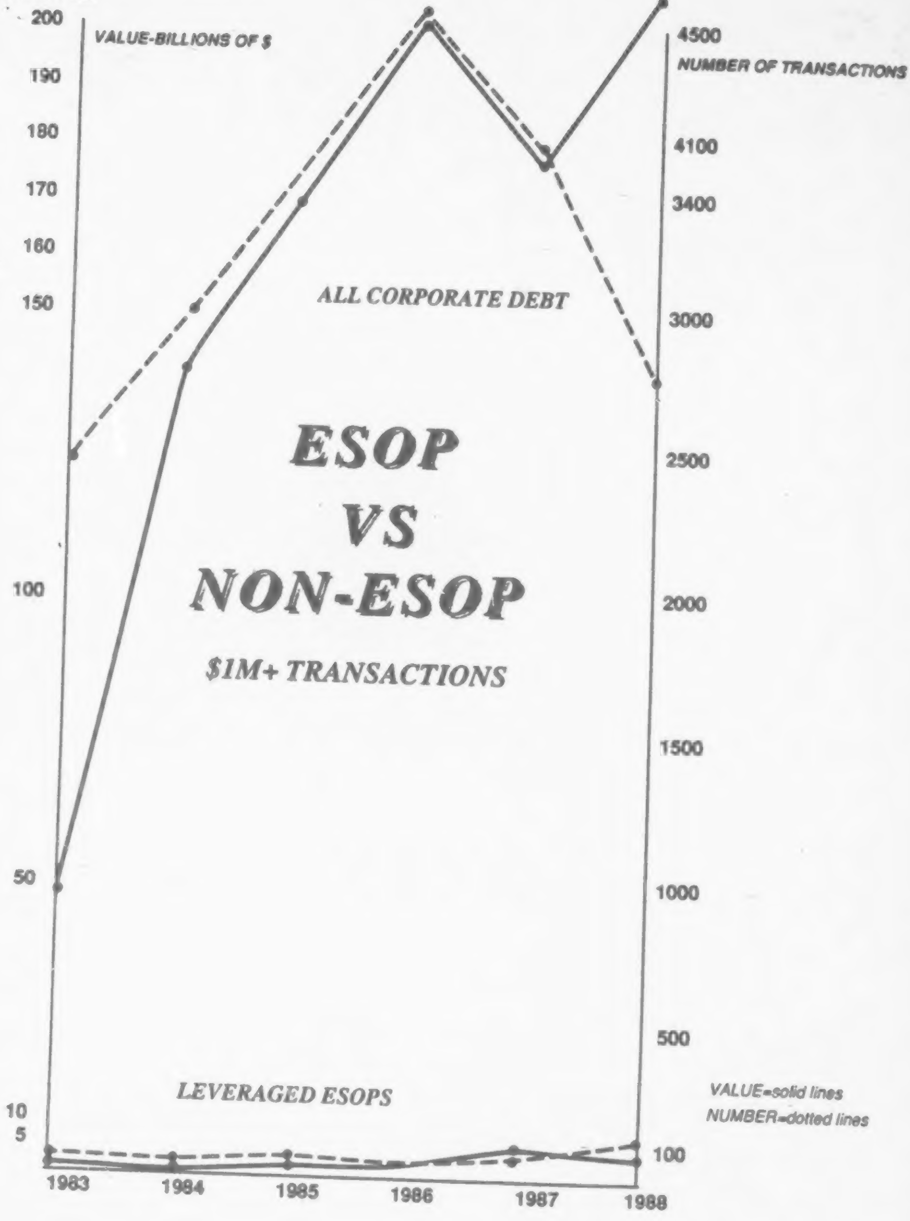


CHART #1
VALUE-BILLIONS OF $
NUMBER OF LBOS
40
35
25
20
15
10
5
4
3
2
1
400
350
300
250
200
100
50
40
30
20
10
NON-ESOPS
LBOS
ESOPS
VALUE=solid lines
NUMBER=dotted lines
1983
1984
1985
1986
1987
1988

CHART #2



ESOP VS NON-ESOP

$1M+ TRANSACTIONS

Mr. **Guarini**. Ms. Sarah Teslik, Council of Institutional Investors.

STATEMENT OF SARAH A.B. TESLIK, EXECUTIVE DIRECTOR, COUNCIL OF INSTITUTIONAL INVESTORS

Ms. **Teslik**. As the last speaker on the last panel, the last day of hearings, I know one thing is expected of me. Brevity.

Mr. **Guarini**. We have always insisted on a statement.

Ms. **Teslik**. Although I work for 65 pension funds who invest their $300 billion with only the long term in mind, I will be a model short termer. Two points.

One, even if you believe LBO's and other corporate restructurings are a deadly disease that destroy America's corporations, communities and marriages, pension funds are not the virus. We contribute $3.5 billion to LBO pools. That is all pension funds. While that sounds like a lot, in the pension fund world it is not even an adult-sized number. It represents only about two-tenths of 1 percent of total pension assets which are $1.7 trillion. If you widen the picture some to include junk bond investments as well as LBO pool investments, you go up to between 1 and 2 percent of total pension assets. This accounts for 15 percent of all junk bond financing. While these dollars and percentage numbers are small, the number of players involved from the pension point of view is even smaller. From the survey of our members and a survey of the Association of Corporate Pension Funds, there are about 23 of the largest pension funds that are known to have any investments at all in LBO pools. Just to put that in perspective, there are 2,600 State and local government pension funds. Only are 12 of these have any kind of LBO investment. Furthermore, if you look at these 12 or you look at the 23 all together, I know of only two or three of those 23 that have invested more than 5 percent of their funds in these high risk investments.

Finally, little new money is going into either LBO pools or to junk bonds. In a survey published last month by Institutional Investor, 90 percent of reporting funds indicated they planned no 1989 money to be invested in LBO pools or junk bonds. Only four-tenths of one percent of those indicated they would put more than 10 percent into a combination of LBO's or venture capital.

It is sometimes alleged, despite these facts, that pension funds are to blame for LBO's—or whatever the market villain du jour is—because we are vicious and myopic short-termers and that you should change the laws to prevent us from acting this way. Again, the facts don't bear this out. Pension funds' annual turnovers are low and they are getting lower. We are completing a survey of our members where our information from our larger funds—who have the figures available—indicates their average annual turnover figure is between 10 and 40 percent. It wasn't this way 5 years ago. Each year those numbers get lower.

In addition, we are finding that our average member holds an individual company stock for a longer period of time than the average corporate executive holds his job. It is always a period of years. It seems to be 5 to 7 years. It is hard to trace it back farther than that in a lot of cases. In other words, if there is a problem, we are not it.

The second and final point, we should not be part of the solution. There have been a lot of proposals around that suggest that pension funds should be the vehicle to stop whatever the current market concern is, LBO's, whatever. Pension funds cannot be an effective tool against any policy concern unless you are either denying them access to a good investment, forcing them into an unwise investment or otherwise directly or indirectly taking money from them. Otherwise, they are not effective. It is simply a wash. There has been a lot of talk about the concern about the debt at the national level, at the corporate level and at the personal level. Pension funds are an oasis of savings in a desert of debt. It seems to me this body should be very slow to attack those reserves unless there are no other policy alternatives. Thank you.

Mr. GUARINI. Thank you very much. Is there any concern on your part about the ability of companies to adequately fund the pension plans after an LBO? Has it been a problem in this area?

Ms. TESLIK. Our members have public funds and union funds, and while I know something about it, I am not an expert on corporate funds and the parent corporations.

Mr. GUARINI. Some people who have testified earlier recommended that a portion of the interest that is now tax exempt on behalf of the pension funds be included as taxable income. I imagine your answer goes without saying that you would be against this.

Ms. TESLIK. There is no current council policy on it. We have looked at a number of different taxing options. One, although it is not a council policy, that was received with some favor at a meeting last week was the proposal written up a couple weeks ago, I saw it in the Economist, that you reduce by the inflation component taxable and tax-deductible debt.

It seemed to me there were a number of positive policy things connected with that and fewer of the down sides, and it doesn't seem to have the cost to the government other proposals do. That is not official policy.

Mr. GUARINI. Dr. Ture, when we talk about debt and talk about equity, is there a point where if the interest rate is at a point where it is several times the tax rate, several times the prime rate, that it could be—should be considered as equity instead of debt? Should we give deductions regardless of how high the bond interest rates are, which is just being subsidized by our taxpayers? Does risk come into play at that point philosophically?

Mr. TURE. Neither philosophically nor analytically or as a matter of good tax principle, in my judgment. I don't know of a principle of income taxation that argues that the rate at which any payment for a productive service is made determines whether or not it should be deductible, whether it is a true expense or invalid expense.

I would argue very strongly against trying to make that kind of distinction on the basis of the level of the rate that is paid. I think you ought to interpret that rate, as many witnesses have suggested to you, as primarily a measure of the risk that is attached to that kind of instrument.

Mr. GUARINI. Thank you. Mr. Schulze, you have given us a very good American story of a company that seems to have come through with flying colors. Originally, when you took over your company and went private, were jobs lost originally while you pruned the company on the management side, as well as the labor side? Could you relate to what happened in employment short-run as well as long-term in the company as you took it over?

Mr. ERWIN SCHULZE. Well, if I can go back, in the early 1980's, it was apparent to all of American industry, at least apparent to me, that we had to make ourselves more cost effective. I think throughout the country you will see companies that have engaged in cost reduction programs in order to increase their competitiveness. We had such a program going on from 1982 right through 1986, and, frankly, we had finished the program by the time we got into the LBO.

Since the LBO employment increased both in 1987 and in 1988. We did close two small facilities, one in Atlanta that I think had four or five employees, and another one in the Northwest, which also had a relatively few number of employees. But those were strictly economic decisions. They had nothing to do with the LBO.

Mr. GUARINI. Every time there is a leveraged buyout, there has to be a pruning of some sort, a recognition of the fact that you have got to cut costs in order to pay for the high interest rates that might be assumed in a LBO. Doesn't it actually mean that many people who have been working for many years in management and in the labor force are going to be displaced? Is not provision made for these people?

Mr. ERWIN SCHULZE. I guess the answer to that is yes, there is a pruning that goes on, but, no, it is not bad, it is good.

Mr. GUARINI. Except if you are the one who lost your job.

Mr. ERWIN SCHULZE. In my case, for example, those men who retired—and they all did retire—we had a policy for them in which they not only were able to obtain early retirement, but got full early retirement without actuarial reduction. That was very costly to us. It costs us several millions of dollars.

But as a result of that, we had no complaints from those people, they understood what was going on. It is true that you do reduce fat in an organization, but that is good, that is not bad.

Mr. GUARINI. Thank you, Mr. Schulze. Mr. Moody.

Mr. MOODY. It has been a long day. I appreciate the points you have made. Do any of you feel that there is something wrong that needs to be fixed, or are you in agreement we should just leave this system alone? Any of you.

Mr. ERWIN SCHULZE. I could respond to that. I think the public perception is that these have excesses that have caused some kind of outcry, and something ought to be done about that. But when you look at the question of whether or not increased debt at the corporate level is bad or good, I think, in my judgment, that is not the problem.

Mr. MOODY. You don't think it is neither bad nor good?

Mr. ERWIN SCHULZE. I think it is better. It is slightly good. It is making us more like our competition. When I competed against Japan, I was competing against companies that had a 90 percent debt-to-capital ratio and a 3.5 percent cost of debt. That is a pretty tough company to compete against.

Mr. MOODY. Your argument is their cost of capital is lower because they——

Mr. ERWIN SCHULZE. Interest rates are lower, and they have more debt than equity.

Mr. MOODY. Interest rates are much lower, but that is not an issue here. We are not talking about interest, but the cost of interest.

Mr. ERWIN SCHULZE. That is part of how you determine cost of capital.

Mr. MOODY. Of course, but cost of interest is determined by something far beyond the scope of today's conversation. That is a constant. With interest differentials between Japan and America being what they are—you are saying they not only have lower unit cost of debt, they have far more debt.

Mr. ERWIN SCHULZE. Proportionate to their equity, that is correct.

Mr. TURE. Could I be responsive to your question?

Mr. MOODY. One of the reasons I want to ask this question is that we described yesterday a fragility problem in the economy. A professor said he is concerned about the fragility building up because of that huge debt equity ratio. Sorry. Go ahead, sir.

Mr. TURE. I hadn't intended to comment on the fragility question, but let me start by responding to your question with that. I personally have heard about the fragility issue since I first joined the Reagan administration, the beginning of 1981. I never—I can't think of a day in the year and a half that I served that administration that I did not hear about how fragile the Reagan program was making the state of the U.S. economy.

And that is an observation which I have found year after year after year since that time, strangely at odds with the solid facts about the economy's performance. The fundamental question you raise——

Mr. MOODY. I am sorry, the economy performance, where interest rates are much higher than America and Japan, is that not one of the manifestations of the policies?

Mr. TURE. Interest rates are much, much lower than they were at the beginning of 1981, where the unemployment rate is much much lower, where the number of jobs that have been added are extraordinarily high, where productivity in the manufacturing sector has overcome a long, long lag, indeed, a negative growth rate. Where indicator after indicator shows you have a very substantial degree of strength in the economy, and it is very difficult at this point to discern any elements of significant weakness.

I am not making a forecast, Mr. Moody, that we are forever more going to be a prosperous economy. I think there are natural adjustments that occur in a dynamic environment like ours, and it wouldn't surprise me at all to see them occurring again in the near future.

But may I address the question that you raised because I really do think it is a fundamental question. Another way of paraphrasing it, is there a way of interpreting these changes in corporate structure and changes in ownership and in management and the associated high leveraging as indications of market failure?

And my response to that would be you could probably make up a long list of economic indicators, and if you could associate negative changes in those indicators with this phenomenon in some rigorous, analytically solid way, then I would say you have a case. I can't do it. I don't know of anybody who has done it. I see a lot of assertions to this effect, but those scholars who have approached this matter in a scholarly and objective way, it seems to me, have for the most part come up with a negative conclusion on that question. They have discovered this to be a market phenomenon that on the whole tends to improve efficiency in the economy's operations.

I suspect that the score has yet to be finally tallied on this, but it is difficult for me to see that the occasion for the concern of this committee is some evidence of market failure. I would suggest to you again that the appropriate concern of the committee is the observation which has been made to you over the years repeatedly, that the tax law is biased against equity and that bias ought to be relieved by doing something on the treatment of dividends and capital gains.

Mr. MOODY. On that very point—could I just finish this up? You and others have made the case about how this process we are watching shifting from equity to debt is good. As a pruning out of inefficiency, it makes us more competitive for reasons cited and so forth. If that is so, how can the people say that we can alter tax treatment to stop the very tax device which is creating this? The same people who argue this is good also argue we should immediately stop taxing dividends differently than interest rates.

It seems if anything we should increase the differential since the very same people who sat up here arguing this is a good thing are the same people who have told us this tax treatment should be immediately leveled out. There is a logical inconsistency in the position.

Mr. TURE. My point is not that the increase in debt is either good or bad. I think that the way in which people undertake property rights to convey financial assets to corporations should be determined in the freest possible market. I think there is an institutional bias in the tax law against equity, and I would remove that bias if I had the authority to do so and let the market work out as it would—I am sure that we would still find any number of opportunities where highly leveraged debt would be the most efficient kind of instrument for conveying financial resources from individuals to corporations. That wouldn't disturb me in the least.

Mr. MOODY. Thank you.

Mr. GUARINI. Mr. Sundquist.

Mr. SUNDQUIST. Thank you, Mr. Chairman.

I would like to thank the panel for your testimony and for balancing out some views that we have heard today that differed from previous testimony.

Mr. Schulze, I would like to say a special thanks to you for Ceco's investment in Tennessee, for a very effective, efficient and high quality plant, for the jobs that you provide in Tennessee and for your view that we shouldn't look at all LBO's the same way. I am particularly grateful for your views, as I understand what you are saying, that we have to be sensitive to some smaller firms in the use of LBO's and not paint all the LBO's with the same brush.

Mr. ERWIN SCHULZE. Correct.

Mr. SUNDQUIST. We have had testimony the last couple of days by some including the Secretary of Treasury, who say that we should wait to see if the trend in LBO's has peaked out and whether it is going to start diminishing. Do you have any feel for that?

Mr. ERWIN SCHULZE. Yes, I do really. I think that in terms of the mega-LBO, yes, perhaps that may have peaked out. I have no idea, but subjectively, I think that might have occurred. I went—I was in business running companies back in the 1960's, and in the Midwest we would have a large number of very successful family companies and when the family string ran out, the issue was what do I do? What they had to do was go to the giants of the world and the Gulf & Westerns and big conglomerates and sell out, and I didn't think that was good for the Midwest.

And today we have a device which permits the employees and the managers of that company to buy it from the family at a very good price, and they do it by means of a LBO, and I think that is absolutely great, and I would hate like heck to see that changed. I think that is going to continue.

Mr. SUNDQUIST. What, though, about the giants who use LBO's and the shift in the giants, seemingly the giants, toward creating the debt, and not investing therefore in R&D or in new equipment that might ultimately cost us some investment, or some competitive skills? What is your reaction to that?

Mr. ERWIN SCHULZE. I am not——

Mr. SUNDQUIST. In other words, I understand what you are saying about the family-owned businesses and the transition and that area, but what about the giants? Should we on this committee look at that? Should we do something about it?

Mr. ERWIN SCHULZE. Well, in my view, then Dr. Ture can respond—in that case, I think that competition and free market forces are the things that require big and small companies to invest in their future. And to the degree that a giant is slovenly, lazy, entrenched, not invested, that company is going to be punished in the marketplace and something is going to happen to that management, or should. I think that is the way that works.

Mr. SUNDQUIST. Dr. Ture.

Mr. TURE. May I add to what Mr. Schulze just observed to you, which I substantially agree with, one of the more usual than otherwise characteristics of these restructurings is down-sizing, and the larger the company, the more substantial the visible down-sizing often is. That down-sizing doesn't occur just out of malice, it occurs as part of an effort to put the company on a more—various component parts of the company on a more efficient basis.

The effort to do so may very well involve a decrease in the aggregate amount of dollars that is spent on one or another kind of activity, including R&D. R&D has a gloss to it that most of us hesitate to challenge. But realistically we know there is an awful lot of R&D activity that is undertaken simply because management perceives the cost of it to be very low.

And one of the consequences of these restructurings, it seems to me, is that management reassesses all parts of the company's operations, including R&D, and tries to cast off those programs which do not have high promise.

Mr. Sundquist. I know my time is up. The point you make is a good one on down-sizing. And we talk about the creation of the big companies and this is one way that they will be broken down into smaller parts, and, therefore, hopefully become more competitive.

But the fact is that we are looking at the debt/equity area. You know our tax law drives things; we are not in a free market in that sense, because subtle changes here make big differences in what happens in companies.

One other point I want to make, and that is, Mr. Schulze, it seems to me that you said that the higher debt is not dangerous as you see it in these size companies, and you compared it with the debt in other countries, particularly in Japan. But isn't there a relationship that exists in Japan between the financial institutions and the companies that does not exist here, and isn't there less of a chance for failure in those companies in times of a recession? Isn't that one of the things we are concerned about, when a company takes to this high debt and then the fragility, as my colleague said, that would occur in this country that wouldn't perhaps occur in Japan?

Mr. Erwin Schulze. I suspect you are right to a degree, and I think that is what does, in fact, happen in this country, at least with high-yield bond situations. If you have your long-term creditors involved with the company, and if a company gets in trouble, they will work their way out of that problem. That is the way in which it ought to be worked out under our system, and I think that is the way it would be worked out.

Mr. Sundquist. As long as they don't come to us, as has happened in the past. That is the danger.

Mr. Ture. I think we ought to award Mr. Schulze an honorary doctorate in economics, because he has made some extremely sophisticated observations. One of the things that ought to be borne in mind is we ought to look at these debt transactions not only from the point of view of debt issuer, but from the point of view of the lender. Lenders must take into account the risk of default when they assess the desirability of investing in the debt issue.

I think that it would do us all a great deal of good to have just a tad more respect for those participants in the financial market who are putting their money at risk. They are no more Polyannish about the state of the economy than any of us sitting here. They must be aware of the risk of recession, and they must take that into account when they consider whether or not to invest. I wouldn't stop them for a moment from making that.

Mr. Sundquist. That doesn't speak well of the savings and loan problem we have.

Mr. Ture. That is an entirely different matter.

Mr. Guarini. That is another day, another battle, another war that is going to be fought. Mr. Vander Jagt.

Mr. Vander Jagt. No thank you, but I thank the members of the panel.

Mr. GUARINI. I want to particularly thank the members of the panel. You have been very patient, you have stayed throughout the day, you have given us the benefit of your experience, particularly at the grassroots, and I want to thank you very, very much on behalf of the committee, and I wanted to also extend that thanks to all the people who for the last 3 days have been here testifying on behalf of leveraged buyouts.

We will continue these hearings on leveraged buyouts in March at a date to be announced, but we will have our next hearings on Tuesday, February 7, on the budget. So until such time, we will adjourn. Thank you very much.

[Whereupon, at 3:20 p.m., the committee was adjourned subject to the call of the Chair.]

TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

TUESDAY, MARCH 14, 1989

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. The committee will come to order.

Good morning. This morning the Ways and Means Committee begins a second week of hearings on leveraged buyouts and other transactions which result in corporate equity being replaced by debt.

Since the committee started taking testimony on January 31, we have heard from a wide variety of Government policymakers, industry experts, and academicians regarding these complex issues. We have heard different opinions regarding the dangers of recent transactions which have greatly increased levels of corporate debt.

Witnesses have provided us with a full range of options if this committee decides to legislate in the area. Some witnesses have proposed limitations on the deductibility of interest. Others have advocated providing some relief for corporate equity, and several have suggested taking a wait and see approach and not legislating at this time.

We have also received testimony concerning the impact of these transactions on the labor force and other segments of the economy.

We have heard concern about the impact of potential actions this committee might take upon our competitiveness with foreigners. We have also heard concerns expressed regarding the impact of these transactions on Federal revenues and the corporate tax base.

The members of the committee have had the opportunity to discuss these issues informally after the first 3 days of hearings. Many viewpoints were expressed, but we were uniform in our appreciation of the usefulness of these hearings and the suggestions of many of the witnesses.

Today we will continue to improve our understanding of these issues. We will hear from the National Science Foundation, professional associations, corporate executives, practitioners, and other witnesses familiar with these transactions.

It is unclear where these hearings will lead the committee. After we take testimony today and tomorrow, I plan to consult again with the members of the committee before reaching any decision as to the next step in this process. Perhaps if the members believe it useful, further testimony could be taken on a variety of specific legislative approaches. In any event, although the direction this committee may take is not obvious at this time, it is clear that this hearing process has provided a tremendous increase in the level of understanding of these issues by the committee.

This morning we will begin with Erich Bloch, Director of the National Science Foundation.

Mr. Bloch, it is a pleasure to have you with us today.

Mr. Archer.

Mr. ARCHER. Mr. Chairman, I am pleased that you have taken the position that we move very conservatively and slowly into this area, so that we know precisely what we are doing, and that any action that we might take not be counterproductive to our goals.

There is great difficulty in determining whether or not the use of debt is advantageous or disadvantageous to a particular corporation. I particularly appreciate your comment today that if any specific pieces of legislation or proposals are considered by the committee, we will again have hearings to determine what impact they might have. I compliment the way the committee is moving on a bipartisan basis, and I welcome the testimony this morning.

Chairman ROSTENKOWSKI. Mr. Bloch, you may begin.

STATEMENT OF ERICH BLOCH, DIRECTOR, NATIONAL SCIENCE FOUNDATION

Mr. BLOCH. Thank you very much, Mr. Chairman.

I have the detailed statement for the record, and I will summarize it very briefly.

Recently, the National Science Foundation, in line with our enabling legislation, examined the effects of mergers, leveraged buyouts, and other types of restructurings on industry's financing of research and development. This was done by using data from our annual Survey of Industrial Research and Development.

Industry performs over 70 percent of total U.S. R&D, and provides about half of the funds spent on research and development in the United States each year.

Recently, for the first time in a decade, we were surprised to observe zero real growth in industry's use of its own funds for R&D. Allowing for inflation, the figure for 1987, about $55 billion, was almost exactly the same as in 1985 and 1986.

In contrast, industrial R&D funding climbed steadily during the preceding decade, averaging about 5.8 percent per year in real terms. Because this trend was maintained even during the recession in the early 1980's, the break in the trend is especially disturbing. Chart 1 attached to my testimony shows clearly the break in the long-term trend that occurred after 1985.

There could be many reasons for this. Among others, a possible explanation for the break is that the recent increase in corporate mergers and LBO's has reduced support for R&D and has reduced support for R&D in the affected companies. The data we have tend to support this hypothesis.

From among the 200 largest R&D performing companies, we identified 33 firms that had merged into 16 resulting companies, plus 8 additional firms that had been restructured since 1984. Each of the 16 merged firms had R&D expenditures exceeding $100 million. The 8 companies involved in LBO's had smaller programs ranging from $25 million to $250 million.

But the 16 mergers and the 8 firms involved in LBO's or other restructurings accounted for almost 20 percent of total R&D funding spent by all firms in 1987. This is a significant group of companies to study, although the focus should be on the merger firms. The LBO firms are a fairly small part of the picture.

What we found was disturbing. These 24 companies had a combined 5 percent reduction in current dollars in R&D spending, and an 8 percent reduction in constant dollars between 1986 and 1987.

In contrast, the remaining top 200 R&D performing companies reported a 5.4 percent increase in current dollars in R&D expenditures during the same time period. Charts 2 and 3 in my written testimony present these data graphically.

The trend in employment of R&D scientists and engineers is similar. Almost all of the firms that reported reduced R&D spending also reported a decline in R&D scientists and engineers. In almost all cases, however, the cutback in personnel was less than the reduction in R&D funds. For these companies, the decrease in R&D personnel was 4.1 percent between 1986 and 1987. Total industrial employment of R&D scientists and engineers, on the other hand, increased 1.8 percent in that period.

Reductions in personnel may have been less than reductions in R&D funding, because companies may tend first to cut other things, like capital investments in instrumentation and facilities, for instance, before they cut manpower.

These findings are corroborated by reports of the members of our industrial panel on science and technology, who represent companies involved in mergers. These members were more likely than other respondents to report a decrease in their companies' R&D budgets and to cite the merger as the reason for the decline.

The data I have presented describe only what is happening at the present time, and only for 1 year. They do not tell us what the long-term effects of mergers and restructurings will be. A possible interpretation, for instance, is that reductions do not represent actual cuts in R&D. These firms may simply be eliminating duplication in their programs.

In addition, the reductions almost certainly reflect other factors, such as reduced sales, increased competition from abroad, or other company-dependent kind of problems. However, we have to look at this issue over a longer period of time to chart the impact on industrial R&D spending in the United States.

In closing, Mr. Chairman, R&D is an investment in the future of a company, industry, and the country—it is not a consumption item. R&D is an early indicator of future competitiveness in the marketplace, and it is therefore worrisome to see the country's industrial research investment declining when we face increased competition from abroad and increased spending for R&D by our trading partners.

Thank you very much.

[The statement of Mr. Erich Bloch follows:]

Testimony of

Mr. Erich Bloch

before the

HOUSE WAYS AND MEANS COMMITTEE
U. S. HOUSE OF REPRESENTATIVES

March 14, 1989

"Effects of Corporate Restructurings on R&D Support"

I appreciate the opportunity to discuss a recent National Science Foundation (NSF) study that examined the impact of mergers, leveraged buyouts, and other types of restructurings on industry's financing of research and development. The study was conducted at the request of Chairman Markey of the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce, using data from the Foundation's annual Survey of Industrial Research and Development.

Among other responsibilities, the National Science Foundation is charged with providing analytical data on scientific and engineering resources. We use several sources of information on industrial research and development, of which the most extensive is an annual Survey of Industrial Research and Development done for the Foundation for the past thirty years by the U.S. Bureau of the Census. We supplement this with information gathered through annual polling of our Industrial Panel on Science and Technology, which includes representatives of about 100 of the largest R&D-performing companies, and with information obtained from R&D directors.

Industry performs over 70 percent of total U.S. R&D, and provides half of the funds spent on R&D in the United States each year. Recently, for the first time in a decade, we were surprised to observe zero real growth in industry's use of its own funds for research and development. Industrial firms invested an estimated $54.6 billion of their own funds in research and development in 1987. After allowing for inflation, this was almost exactly the same amount as in 1985 and 1986. In contrast, industrial R&D funding climbed steadily during the preceding decade, averaging 5.8 percent per year in real terms. Because this trend was maintained even during the recession in the early 1980s, the break in the trend after 1985 is especially disturbing. (Chart 1)

A possible explanation for this break in the long-term trend is that the recent increase in corporate mergers and restructurings (including LBO's) has reduced real support for R&D in the affected companies -- at least temporarily, until the effects of the mergers and restructurings have run their full course. The data we have tend to support this hypothesis.

We have examined data for those companies involved in mergers, LBOs or other restructurings during 1984, 1985, and 1986. Only the 200 largest R&D performing companies were studied, because these firms account for almost 90 percent of industrial R&D spending in the U.S.

From among the 200 firms, NSF and Census Bureau staff identified 33 firms that had merged into 16 resulting companies, plus eight additional firms that had been restructured (including several LBOs or stock buybacks). Each of the 16 merged firms had R&D expenditures exceeding $100 million; 7 ranked among the largest R&D performing companies in 1987, each spending more than $350 million.

The eight companies classified as LBOs or other restructurings had smaller R&D programs, ranging from $25 million to $250 million. It is important to note that this group of companies does not include any that sold off significant R&D-performing divisions during the period examined. Companies that sold off divisions were eliminated from the study in order ensure consistent data from one time period to the next.

The 16 mergers and the eight firms involved in LBOs or other restructurings accounted for almost 20 percent of the total $54.6 billion spent by all firms in 1987 ($9.2 billion and $600 million, respectively). This is a significant group of companies to study, although the focus should be on the merger firms: the LBO firms are not among the major R&D performers and thus are a fairly small part of the picture.

The result of this analysis is disturbing. These 24 companies had a combined 5.3 percent reduction in R&D spending, even in current dollars, between 1986 and 1987. The decline in real terms amounted to 8.3%. In contrast, the remaining top-200 R&D-performing companies reported a 5.4 percent increase in R&D expenditures during that period. (Charts 2 and 3)

The effect of merger activity may also be seen at the industry level. Six of the 16 mergers involved companies classified in the transportation equipment industry. These companies had a 5.5 percent reduction in current dollars in R&D spending between 1986 and 1987. In contrast, R&D funding in the remainder of the transportation equipment industry rose 2.4 percent between 1986 and 1987. Similarly, in the chemicals and pharmaceutical industry, companies affected by mergers and other restructurings had a 4.5 percent increase in R&D spending whereas the rest of the industry reported a 9.8 percent increase.

The trend in employment of R&D scientists and engineers is similar. Almost all the restructured firms that reported reduced R&D spending also reported a decline in scientists and engineers. In almost all cases, however, the cutback in personnel was less than the reduction in R&D funds. For these companies, the decrease in R&D professional personnel was 4.1 percent between 1986 and 1987, whereas total industrial employment of R&D scientists and engineers increased 1.8 percent during that period.

Reductions in personnel may be less than reductions in R&D funding because companies may tend first to cut other expenditures -- especially instrumentation and facilities. Failing to make such investments, however, will soon cause a laboratory to become less productive. Researchers need state-of-the-art equipment in order to be most effective.

For the past two years, we have asked those members of our Industrial Panel on Science and Technology who represent companies involved in mergers to assess the mergers' impact on their companies' R&D support. These polls reveal that R&D directors representing merged companies were more likely than other respondents to report a decrease in their companies' R&D budgets, and to cite the merger as a reason for the decline.

The data I have presented describe only what is happening at the present time. They do not tell us what the long-term effects of mergers and restructurings will be. A possible interpretation, for instance, is that the cutbacks reported do not represent actual reductions in R&D effort; these firms may simply be eliminating duplication and inefficiency in their R&D programs.

In addition, the changes we have observed are recent. While it is clear that restructured companies are generally reporting reductions in R&D support, the reductions almost certainly reflect other factors as well. For example, we have been told by R&D directors in industries such as petroleum that disappointing sales have restricted the resources available for R&D. Increased competition from abroad and the desire for short term profits may also be factors.

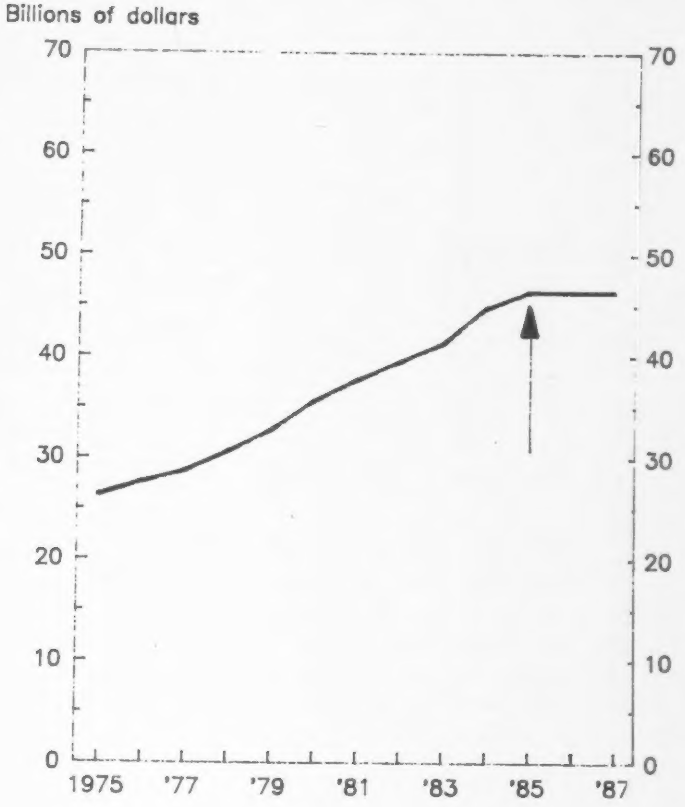
A drop in R&D funding in the computer industry in both 1986 and 1987 was another factor partially responsible for the lack of real growth in industrial R&D spending. After many years of above average increases in R&D expenditures by this industry, it appears to be on a plateau. According to industry officials, R&D activity should soon show a turnaround.

It is too early to say confidently that restructurings are the major factor behind the cutbacks in R&D spending. Neither we nor other researchers have data for a long enough period to accurately assess the effect of restructurings relative to other factors. We will continue to track the companies in our study and any additional restructurings that occur over the next few years so as to better assess the impact of mergers and LBOs on industrial R&D performance.

But it is worrisome to see our industrial research investment declining when we face increased competition from abroad and increased R&D spending by our trading partners.

Chart 1

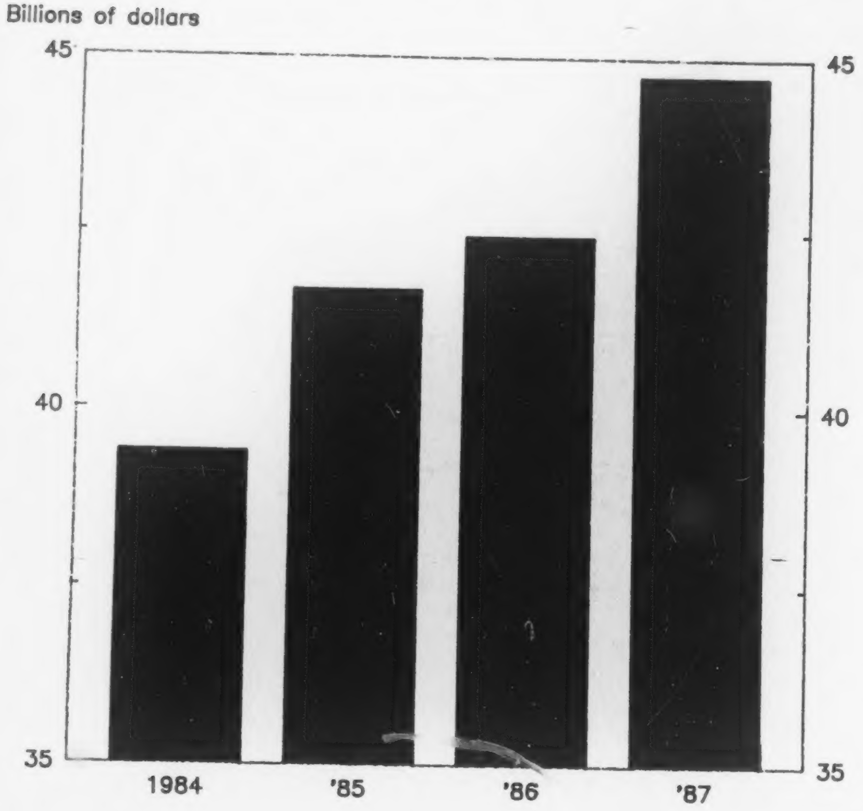
Companies' own R&D expenditures in constant 1982 dollars



SOURCE: National Science Foundation, SRS

Chart 2

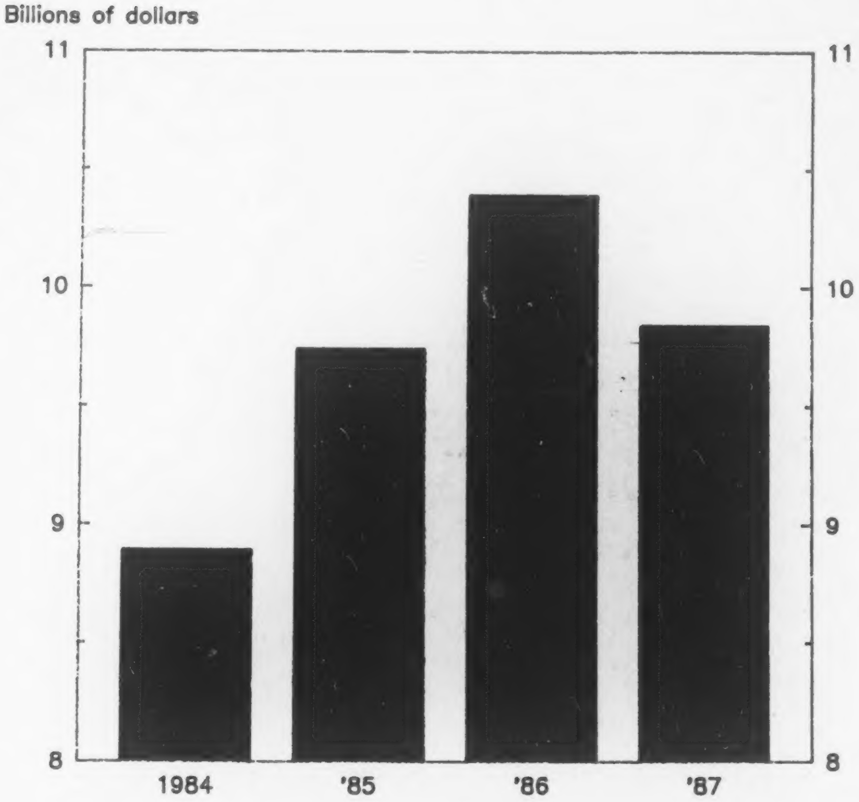
All other companies' R&D expenditures



SOURCE: National Science Foundation, SRS

Chart 3

Restructured companies' R&D expenditures



SOURCE: National Science Foundation, SRS

An Assessment of the Impact of Recent Leveraged Buyouts and Other Restructurings on Industrial Research and Development Expenditures

Prepared by the National Science Foundation for
the Subcommittee on Telecommunications and Finance,
House Committee on Energy and Commerce

February 1, 1989

In response to a request from the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, National Science Foundation staff examined data provided by the 200 leading U.S. R&D-performing companies for the annual Survey of Industrial Research and Development. All industries were included, but only the transportation equipment and chemicals (including drugs and medicines) industries are mentioned separately, because Title 13 of the U.S. Code prohibits disclosure of information that could reveal identities of individual companies.

- Following ten years (1975-85) of increases averaging 5.8 percent annually after adjustment for inflation, real growth in company funds for research and development has all but disappeared, according to data from the National Science Foundation's (NSF) annual Survey of Industrial Research and Development. Analysis of the data shows that reductions in R&D expenditures by companies involved in mergers, acquisitions, and other restructurings including leveraged buy-outs (LBOs) appear to be a major factor responsible for the lack of real growth in industrial R&D spending in the mid-eighties.

- Industrial firms invested an estimated $54.6 billion of their own funds in research and development in 1987, virtually the same level of spending as in 1985 after adjustment for inflation. Of the 200 companies that together account for almost 90 percent of total company R&D funds, 16 large R&D performers were identified by NSF staff as recent mergers. Each of these 16 firms spends more than $100 million in company funds on research and development. These 16 firms, together with an additional 8 firms that were involved in LBOs or other restructurings and which also rank among the leading 200 R&D-funding companies, accounted for almost 20 percent of the total spent by all firms in 1987 ($9.2 billion and $600 million, respectively).

- These 24 companies had a combined 5.3 percent reduction in R&D spending in current dollars between 1986 and 1987. In contrast, all other R&D-performing companies reported a 5.4 percent increase in their R&D expenditures during that period.

- Eleven of the 16 mergers occurred between August 1985 and September 1986, and five occurred either in 1984 or in early 1985. For the one-, two-, or three-year period after the merger, nine of these companies reported significant reductions in their R&D budgets, four had increases, and three had little or no change. In current dollars, these 16 combinations of companies together had a 4.7 percent annual reduction in their own R&D expenditures, whereas R&D spending by all U.S. companies rose 3.3 percent between 1986 and 1987.

- The eight companies involved in leveraged buy-outs, buy-backs, or major restructurings (to avoid becoming targets of takeovers) have R&D programs ranging in size from $25 million to $250 million. Each of these firms had a significant reduction in R&D spending between 1986 and 1987. Together, the total decline was 12.8 percent.

- Mergers, acquisitions, and other restructurings had a dampening effect on their respective industries' R&D performance. For example, 6 of the 16 mergers involved companies classified in the transportation equipment industry. These companies had a 5.5 percent reduction in current dollars in R&D spending between 1986 and 1987. In contrast, R&D funding in the remainder of the industry rose 2.4 percent between 1986 and 1987. Similarly, in the chemicals (including drugs and medicines) industry, companies affected by mergers, acquisitions, and other restructurings had a 4.5 percent increase in R&D spending whereas the rest of the industry reported a 9.8 percent increase.

- Decreases in R&D funding also have an impact on employment of R&D scientists and engineers. The trend is similar to that for R&D funding. Almost all firms that had a reduction in R&D spending also reported a decline in their employment of R&D scientists and engineers. In almost all cases, however, the cutback in personnel was somewhat less than the reduction in R&D funds. For these companies, the decrease in R&D professional personnel was 4.1 percent between 1986 and 1987, whereas total industrial employment of R&D scientists and engineers increased 1.8 percent during that period.

- It should be noted that currently available information does not permit an assessment of long-term effects of mergers and acquisitions on company-sponsored R&D activities. For example, a few company officials have indicated that the cutbacks reported may not represent actual reductions in R&D effort; instead these firms may simply be eliminating duplication and inefficiency within their R&D programs.

R&D expenditure data for selected restructured companies

Type of change	Number of companies	1987 company R&D funds	1986-87 change	Comparison with other top 200 companies
Merger	16	$9.2 billion	-4.7%	+5.4%
LBO/other	8	$600 million	-12.8%	

Distribution by size of average annual change

Percent change (current dollars)	Number of companies
-50% to -20%	3
-20% to -10%	8
-10% to -2%	6
-2% to +2%	3
+2% to +25	4

Source: National Science Foundation, SRS

Chairman Rostenkowski. Thank you, Mr. Bloch. Are there any questions, Mr. Archer.

Mr. Archer. No. Thank ~~you very~~ much, Mr. Bloch.

Chairman Rostenkowski. Mr. Dorgan.

Mr. Dorgan. Mr. Bloch, this is very interesting and very useful testimony.

We have had a parade of witnesses come before the committee to tell us that all of this activity in takeovers, mergers, and LBO's, is really good for America, and it simply takes sick companies and makes them well.

Your testimony is fascinating because it suggests that there is a cause/effect relationship between a reduction in research and development spending and the takeover activity that we are now studying.

In a world that is increasingly competitive that is a terrible thing to have happen in our economy. Those enterprises that have historically been engaged in substantial research and development outlays are cutting back at precisely the point in time when they ought to be increasing those research and development outlays dramatically.

I think your testimony is excellent, and it provides some very important information to this committee.

Are you fairly confident of the cause/effect relationship here?

Mr. Bloch. No, you can never be completely confident, and you said the right word in the beginning. It suggests something.

By the way, your observation—there might be good effects of mergers and takeovers, could very well be true also. It is not uncommon in a problem to see positive and negative effects.

I just want to warn you that the data we have is for 1 year so you cannot make a long-term trend out of it, but it raises a warning signal. It raises a warning flag, and we should be aware of it. We should look at that problem. We should consider it for what the data essentially says, and we should try to take some counteraction if there is a cause and effect relationship. I do not think the data will establish that, because it is only for 1 year. It is preliminary data, but I think it is very important for this committee to have.

Mr. Dorgan. You would not have to be much more than a beginning accounting student to understand that if you saddle yourself with debt, something has to give someplace else.

Mr. Bloch. That is right.

Mr. Dorgan. The suspicion has always been that those companies that saddle themselves with enormous blocks of debt are going to have to give someplace, and the likely place to give is in research and development and other kinds of similar expenditures.

Again, you studied 33 firms that merged into 16, plus 8 LBO's. These 23 companies represented 20 percent of the previous year's research and development expenditures, and in the next year they were 8 percent lower—in real terms, 8 percent lower than previously.

Mr. Bloch. Right.

Mr. Dorgan. That is very important and very sobering information for this committee.

You say that you are taking a snapshot in time, and we need to be careful with the data. I understand that. But I have an awful time believing people who come up here and whose interest is in making money as quickly as possible, tell us that all of this LBO activity is wonderful. The say just load yourself with debt and nothing else will happen, and they will still make all the R&D expenditures.

You are saying that, at least with the snapshot in time that you have taken, the empirical data does not support that.

Mr. Bloch. Well, that is right, and I just want to comment on your point that a company that is saddled with debt really cuts down on expenditures, and as long as R&D is being looked at and treated as a discretionary expenditure, obviously it is prone to this kind of a cutback. If it were looked at more like an investment in the future, which it really is, then I think people would act and companies would act differently.

Mr. Dorgan. Mr. Chairman, again thank you for allowing me to ask these questions. This country must put its public and private sectors back on track, and it is not going to do so with speculation. It is going to do so by making long-term investments in research and development in order to remain competitive in an international market place.

Thank you very much, Mr. Bloch, for the testimony.

Chairman Rostenkowski. Thank you, Mr. Bloch. Thank you for your observation.

Mr. Treiger. Mr. Hoffman. Mr. Schechter.

[Pause.]

Chairman Rostenkowski. Welcome to the committee, gentlemen. If you would identify yourself as you make your statement for the record, the committee would appreciate that. I am sure you all know the format here.

Mr. Treiger, you will begin—then Mr. Hoffman, then Mr. Schechter, and then we will open it up to questions from the committee.

Mr. Treiger.

STATEMENT OF IRWIN L. TREIGER, CHAIR, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, ACCOMPANIED BY ROBERT H. WELLEN, COCHAIR OF TASK FORCE ON LEVERAGED BUYOUTS, AND EDWARD J. HAWKINS, VICE CHAIR, SECTION OF GOVERNMENT RELATIONS

Mr. Treiger. Thank you, Chairman Rostenkowski.

Chairman Rostenkowski and members of the committee, I am Irwin Treiger of Seattle, WA, the other Washington. I am chair of the ABA tax section. Present with me are Edward J. Hawkins, the vice chair of the section for Government relations, and Robert Wellen, who served as one of the cochairs of our task force on leverage buyouts. They will be available to answer any questions which any members may have concerning the tax section's position.

We greatly appreciate the opportunity to present certain conclusions which have been reached by the section of taxation with respect to leveraged buyouts and similar transactions.

The American Bar Section of Taxation, which we are representing here this morning, consists of over 27,000 tax lawyers from across the country. One of our primary goals is to work for the improvement of the tax system, and we take great pride in our ongoing efforts to be of assistance to the Congress, the Treasury, and the Internal Revenue Service in attempting to achieve this goal.

The conclusions which we are presenting here today are those of the section of taxation. They have not been approved by the American Bar Association and, accordingly, should not be construed as representing the position of the association.

As lawyers representing business enterprises, members of the section have observed recent LBO activity closely and have taken great interest in proposals to curtail or regulate it.

Within the section of taxation, as in the Congress and in the business community at large, however, the issues presented by LBO's have proven controversial and difficult. It is hard to determine even whether LBO's present a problem needing solution, or assuming that there is a problem, just what that problem might be.

Last December, to focus the section's attention on these issues, I appointed a task force on LBO's. This task force is now composed of 28 lawyers with broad experience in a variety of tax and corporate law practices. Several members of the task force have served in tax policy positions in Treasury or on congressional committee staffs.

Despite the difficulty of the subject, the members of the task force have reached five conclusions, which have been adopted by the council of the tax section, as section positions and are the subject of my testimony this morning.

The first conclusion is that Congress should proceed very deliberately and should prefer nontax responses to LBO's over tax-oriented ones. Before taking any action to curtail LBO's, Congress should deliberately consider the consequences of such action from the standpoint of competitiveness and overall impact on the economy.

Furthermore, the tax law generally is not adept at distinguishing between beneficial and harmful LBO's. Accordingly, if there are abuses relating to the conduct or financing of LBO's, then Congress and the appropriate executive departments or agencies should attempt to eliminate these abuses by non-tax regulatory means.

The second conclusion is that LBO's and similar transactions do have a tendency to reduce corporate income tax revenues, but the overall revenue impact is not clear. Because interest is deductible, whereas dividends are not, corporate management may reduce a corporation's tax burden by converting corporate equity to debt.

Transactions such as leveraged takeovers, recapitalizations, stock repurchases and extraordinary dividends all may have the effect of converting corporate equity to debt, and therefore of reducing the corporate income tax base. Since the corporate tax rate is generally higher today than the individual rate, such transactions may reduce overall tax revenues, but these transactions also generate tax revenues.

Shareholders usually recognize gain on sales of their stock, and interest paid by the corporation after the transaction is likely to exceed the dividends the corporation would have paid if there had been no transaction. On the other hand, some of the investors recognizing the gain or receiving the interest may be tax exempt.

In view of all these elements, it is difficult to reach a conclusion as to the overall net effect of LBO's on tax revenues.

Our third conclusion is that integration of the corporate and shareholder income taxes could reduce the tax incentive to convert equity into debt. If Congress desires to reduce the tax incentive to convert equity to debt through LBO's or otherwise, then Congress should consider steps to integrate the corporate and shareholder income taxes. If properly implemented, an integrated system would improve the fairness and efficiency of the income tax by imposing the same burden on income from both corporate debt and equity, and also on income from both corporate and noncorporate businesses.

Most of our major trading partners have already adopted partially integrated systems. If complete integration is not feasible at this time, Congress should consider at least partial integration now.

The fourth conclusion is that partial disallowance of interest deductions, targeted at certain debt, could offset any revenue loss resulting from integration. Integration of the corporate and shareholder income taxes may result in revenue loss. If it is concluded that there is a revenue loss, Congress could partially disallow deductions for interest on that corporate debt, which is substituted for equity, that is debt incurred in connection with LBO's, recapitalizations, and so forth.

As an alternative approach, Congress could disallow interest deductions on specified types of "hybrid" or "equity flavored" corporate debt. A disallowance of interest deductions targeted in this manner would be preferable to a general disallowance or limitation of interest deductions. Targeting the disallowance of interest deductions creates a challenge, however, to draft a provision which is not unworkably complex, but which prevents taxpayers from avoiding the disallowance through manipulative transactions.

In any event, deductions for interest on debt incurred by small-or medium-sized businesses should not be disallowed. Also, we do not believe it would be appropriate to distinguish between "hostile" and "friendly" LBO's in terms of tax treatment.

Our fifth and final conclusion is that tax-exempt and foreign investors must be considered. Charities, retirement funds and other tax-exempt entities traditionally, of course, have not paid tax on their investment income. This exemption exists in recognition of the social benefits that such organizations provide. Thus, tax-exempt investors in corporate debt instruments do not pay income tax on interest they receive.

Similarly, to encourage foreign investment in the United States, in certain instances the United States permits foreign investors to receive income from U.S. corporations free of U.S. tax. As a result, since interest is deductible, corporate earnings paid to tax-exempt and foreign investors in the form of interest may not be subject to any U.S. tax. These earnings could, of course, be subjected to U.S. tax by imposing a tax on the interest income of such investors, a step that would entail changing the basic judgment underlying their exemption.

The alternative approach, and the one which we favor, would be to reduce the disparity between debt and equity at the corporate level. This approach would have the incidental result that corporate income allocated to both forms of investment would be subject to similar tax treatment without affecting the tax status of tax-exempt or foreign investors.

The tax issues relating to LBO's fundamentally concern how corporate income is to be taxed. Accordingly, we believe it would be more appropriate to focus on corporate-level mechanisms.

In short, as these conclusions indicate, we are not in favor of precipitous action to reduce LBO activity. We are concerned about the economic consequences of any such action. In particular, we do not believe that basic changes in the corporate tax should be undertaken in an atmosphere of panic. Also, we do not think that the tax law should be used to correct problems which really arise in other areas.

Nevertheless, we recognize that LBO's do have tax consequences, which largely stem from the disparity in the tax treatment of debt and equity. Accordingly, this discussion on LBO's may afford us an appropriate time to consider eliminating, or at least reducing, this disparity, partly as a response to the current LBO activity, and partly as an important long-term tax reform.

Finally, we intend to submit for the record the report of the task force to which I referred. This report should be in final form, ready for submission next week.

Even though, except for the five conclusions which I have enumerated, it does not represent a formal position of the Section of Taxation, but simply reflects the individual views of the members who prepared it, we hope that it will be helpful to you in your work.

Once again, we thank you for the opportunity to speak to you.

[The report referred to was subsequently received and follows:]

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March 30, 1989

Mr. Robert J. Leonard
Chief Counsel
Ways and Means Committee
1136 Longworth
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Dear Rob:

As promised when I testified before the Committee on March 14, 1989, I am sending you herewith a copy of the report of the Section's Task Force on Leveraged Buyouts. The Report supplements the Statement presented to the Committee on March 14.

Both the Statement and the Report are the culmination of more than three months of intense effort by our Task Force, which I appointed on December 12, 1988 in response to the announcement of hearings on the subject by Chairman Rostenkowski. The Task Force, co-chaired by Mark J. Silverman and Robert H. Wellen of Washington, DC, consisted of 28 leading tax and business lawyers whose names are listed on the last page of the Report. Their efforts provided a remarkable example of the contribution the Section is capable of making, through the thoughtful and dedicated efforts of its members.

The Statement delivered at the hearings and the five conclusions set forth at the beginning of the Report were adopted by the Council of the Tax Section and represent the Section's positions. On the other hand, the Task Force Report, which sets forth the background and reasoning for those conclusions, was not submitted to Council for approval and, accordingly, does not represent an official Section position, but rather the independent views of the members of the Task Force.

We hope that you will find the Statement and the Report useful as consideration of the subject of the substitution of debt for equity continues in the Congress and the Treasury.

Once again, on behalf of the Section, please accept our thanks for affording us the opportunity to testify and present our Statement and Report.

Sincerely,

Irwin

Irwin L. Treiger
Chair, Section of Taxation
American Bar Association

Enclosure

4024W

American Bar Association
Section of Taxation

REPORT OF THE TASK FORCE ON LEVERAGED BUYOUTS

Mark J. Silverman
Robert H. Wellen
Co-Chairs

March 29, 1989

INTRODUCTION

Members of the Section of Taxation have closely observed recent leveraged buyouts and have taken great interest in proposals to curtail or regulate these and similar transactions. Within the Section of Taxation, as in Congress and the business community at large, the issues presented by these transactions have proven controversial and difficult. No real consensus has developed within the Section as to whether leveraged buyouts present a problem needing solution, or, assuming there is a problem, what that problem is.

In December 1988, Irwin L. Treiger, Chair of the Section of Taxation, appointed a Task Force on Leveraged Buyouts to focus the Section's attention on these issues. This Task Force includes 28 lawyers with a broad range of experience in tax and business law practice. A list of Task Force participants is attached to this Report.

In consultation with the officers and Council of the Section of Taxation, the Task Force has arrived at five general conclusions or principles to guide any Congressional response to leveraged buyouts and similar transactions. The Section of Taxation has adopted the Task Force's five conclusions, and Mr. Treiger has presented these conclusions to the Committee on Ways and Means. These conclusions have not, however, been approved by the American Bar Association and should not be construed as representing the position of the Association.

The views expressed in the sections of this Report following the conclusions are those of individual members of the Task Force and do not represent a position either of the American Bar Association or of the Section of Taxation. Moreover, while we believe the Report fairly reflects the views of the Task Force members overall, given the complexity of the issues and the diversity of views on these issues, not all members of the Task Force agree with the entire Report. 1/

1/ The co-chairs and members of the Task Force wish to express their gratitude to Stanley Smilack, Steptoe & Johnson, Washington, D.C., and Matthew M. Nolan, Fulbright & Jaworski, Washington, D.C., for their assistance in preparation of this Report.

CONCLUSIONS REACHED BY THE TASK FORCE AND ADOPTED BY THE SECTION OF TAXATION

The five conclusions reached by the Task Force and adopted by the Section of Taxation are as follows:

1. Congress should proceed deliberately and should prefer non-tax responses to leveraged buyouts over tax-oriented ones. Before taking any action to curtail leveraged buyouts, Congress should consider deliberately the consequences of such action from the standpoint of competitiveness and overall impact on the economy. Furthermore, the tax law generally is not adept at distinguishing between beneficial and harmful leveraged buyouts. Accordingly, if there are abuses relating to the conduct or financing of leveraged buyouts, then Congress and the appropriate executive departments and agencies should attempt to eliminate these abuses by non-tax regulatory means.

2. Leveraged buyouts and similar transactions have a tendency to reduce corporate income tax revenues, but overall revenue impact is not clear. Because interest is deductible, whereas dividends are not, corporate management may reduce a corporation's tax burden by converting corporate equity to debt. Transactions such as leveraged takeovers, recapitalizations, stock repurchases and extraordinary dividends (referred to herein as "LBOs") all may have the effect of converting corporate equity to debt and therefore of reducing the corporate income tax base. Since the corporate tax rate is generally higher than the individual rate, such transactions may reduce overall tax revenues. These transactions also generate tax revenues, however. Shareholders usually recognize gain on sales of their stock, and interest paid by the corporation after the transaction is likely to exceed the dividends the corporation would have paid if there had been no transaction. On the other hand, some of the investors recognizing the gain or receiving the interest may be tax-exempt. In view of these and other elements, it is difficult to reach a conclusion as to the overall net effect of LBOs on tax revenues.

3. Integration of the corporate and shareholder income taxes could reduce the tax incentive to convert equity into debt. If Congress desires to reduce the tax incentive to convert equity to debt (through LBOs or otherwise), then Congress should consider steps to integrate the corporate and shareholder income taxes. If properly implemented, an integrated system would improve the fairness and efficiency of the income tax by imposing the same tax burden on income from both corporate debt and equity and also on income from both corporate and noncorporate business. Most of our major trading partners have already adopted partially integrated systems. If complete integration is not feasible at this time, Congress should consider partial integration.

4. Partial disallowance of interest deductions, targeted at certain debt, could offset any revenue loss resulting from integration. Integration of the corporate and shareholder income taxes may result in revenue loss, at least in the short term. To offset this revenue loss, Congress could partially disallow deductions for interest on corporate debt which is substituted for equity (*i.e.*, debt incurred in connection with LBOs and transactions such as leveraged recapitalizations, stock repurchases and extraordinary distributions). As an alternative approach, Congress could

disallow interest deductions on specified types of "hybrid" or "equity flavored" corporate debt. A disallowance of interest deductions targeted in this manner would be preferable to a general disallowance of interest deductions. Targeting the disallowance of interest deductions creates a challenge, however, to draft a provision which is not unworkably complex but which prevents taxpayers from avoiding the disallowance through manipulative transactions. In any event, deductions for interest on debt incurred by small or medium-sized businesses should not be disallowed. Also, we do not believe it would be appropriate to distinguish between "hostile" and "friendly" LBOs in terms of tax treatment.

5. Tax-exempt and foreign investors must be considered. Charities, retirement funds and other tax-exempt entities traditionally have not paid tax on their investment income. This exemption exists in recognition of the social benefits that such organizations provide. Thus, tax-exempt investors in corporate debt instruments do not pay income tax on interest they receive. Similarly, to encourage foreign investment in the United States, in certain instances the United States permits foreign investors to receive interest from U.S. corporations free of U.S. tax. As a result, since interest is deductible, corporate earnings paid to tax-exempt and foreign investors in the form of interest may not be subject to U.S. tax. These earnings could be subjected to U.S. tax by imposing a tax on the interest income of such investors, a step that would entail changing the judgment underlying their exemption. The alternative approach would be to reduce the disparity between debt and equity at the corporate level. This approach would have the incidental result that both forms of corporate income would be subject to tax, without affecting the tax status of tax-exempt or foreign investors. The tax issues relating to LBO's fundamentally concern how corporate income is to be taxed. Accordingly, we believe it would be more appropriate to focus on corporate-level mechanisms.

DISCUSSION OF TASK FORCE CONCLUSIONS

As the above conclusions indicate, we are not in favor of precipitous action to reduce leveraged buyout activity. We are concerned about the economic consequences of any such action, including consequences relating to the international competitiveness of American business. On the other hand, the amount of recent leveraged buyout activity highlights the disparity in the tax treatment of corporate debt and equity. We believe steps to reduce this disparity could be worthwhile as long-term tax reform.

I. Congress should proceed deliberately and should prefer non-tax responses to leveraged buyouts over tax-oriented ones.

Congress should proceed with caution in any efforts to curtail or regulate leveraged buyouts and similar transactions. That is, Congress must determine what, if anything, is wrong with these transactions before legislating to restrict them.

The broad economic and competitive effects of tax law changes aimed at leveraged buyouts are bound to be uncertain. Unless carefully crafted, a tax law change could have an adverse impact on other transactions not related to leveraged buyouts at all. Further, the tax law never has been adept at distinguishing between "good" and "bad" transactions of similar types. Indeed, as tax practitioners, we have found that attempts to enforce social policy through the tax law often produce significant complexity, confusion and unintended results. 2/ For these reasons, we urge Congress to consider nontax responses to leveraged buyouts before resorting to changes in the tax law.

Some of the problems thought to result from leveraged buyouts can be addressed effectively through securities and banking regulation, rather than through the tax laws. For example, some commentators believe that investment bankers may overreach when they underwrite securities or render "fairness" opinions in connection with transactions in which they have an economic stake. 3/ Concerns of this type should be addressed through securities regulation, and the Securities and Exchange Commission is now reviewing its rules as they apply to leveraged buyouts. 4/ Concerns relating to the financial security of the banking system could be addressed by bank regulators. That is, bank regulators could determine that Government-insured deposits should not be invested beyond designated limits in certain types of debt instruments used to finance leveraged buyouts. Alternatively, increased scrutiny by bank examiners of debt issued by highly leveraged businesses may be appropriate. 5/

If Congress does proceed with tax legislation, it is essential that such legislation not adversely affect sales of closely-held businesses. The current wave of publicity relating to leveraged takeovers and management buyouts has involved acquisitions of large, publicly-traded corporations. Historically, however, many acquisitions of closely-held

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2/ For example, many tax practitioners have found complex provisions such as sections 280G (golden parachutes), 999 (international boycotts) and 5881 (greenmail) to produce many results which seem unintended. (Except as otherwise indicated, reference to sections in this Report are to sections of the Internal Revenue Code of 1986, as amended.)

3/ "[S]ecurities firms should not be allowed to underwrite securities for firms in which they have a direct stake themselves . . . ." Tax Policy Aspects of Mergers and Acquisitions: Hearings Before the House Committee on Ways and Means, 101st Cong., 1st Sess. (January 31-February 2, 1989) [hereinafter cited as HWMC Hearings] (Statement by Henry Kaufman).

4/ The Commission has stated that it is examining its rules and disclosure requirements relating to leveraged buyouts, including rules relating to disclosures to investors in leveraged buyouts and to target company debtholders and the issuance of "fairness opinions" by financial advisers. See Securities and Exchange Commission's Regulation of Management Buyouts and Leveraged Buyouts: Hearing Before the House Energy Commerce Committee Subcommittee on Telecommunications and Finance, 100th Congress., 2nd Sess. (December 22, 1988) (Statement by David S. Ruder).

5/ On February 16, 1989, the Board of Governors of the Federal Reserve System issued new guidelines for national banks involved in financing leveraged transactions. Letter from William Taylor, Staff Director, to the Officer in Charge of Supervision at Each Federal Reserve Bank, Subject: Highly Leveraged Financings -- Attachment: Examination Guidelines Regarding Highly Leveraged Financing Transactions.

businesses (usually small or medium-sized) have been accomplished through leveraged transactions, with clearly beneficial results.

Typically, in such a transaction the owner of a business wants to retire and sell his business to a key employee or younger family member who will operate the business. To make the acquisition affordable, the owner sells a small amount of stock to the buyer and then causes the corporation to buy and retire the remainder of the owner's stock in exchange for borrowed cash or a note. This type of transaction is neither new nor abusive. Often it is the only realistic way for the owner of a small business to realize on the value of the business, while permitting a transfer of control of the business to a new generation of management. Any attempts to deal with leveraged buyouts through tax law changes should be carefully limited to avoid imposing an additional tax burden on these closely-held businesses. Congress should also avoid imposing on these businesses the administrative burden of interpreting a complex new tax rule. The exclusion from any such rule for closely-held businesses should be simple and clearly understandable.

II. Leveraged buyouts and similar transactions have a tendency to reduce corporate income tax revenues, but overall revenue impact is not clear.

Leveraged buyouts and similar transactions affect income tax revenues in a variety of ways. The major impact usually noted is the increase in corporate interest deductions resulting from increased borrowing. As practitioners, we have observed that the tax benefits resulting from these interest deductions are significant, but that, on the whole, leveraged buyouts are motivated by economic factors other than taxes.

Several other types of transactions associated with leveraged buyout activity also add corporate debt at the expense of equity and so have similar effects on tax revenues. Reportedly, corporate managements have engaged in these transactions to improve returns on shareholder equity and sometimes as defensive measures against hostile takeovers. These types of transactions include:

- Leveraged recapitalizations, in which the corporation issues new debt instruments in exchange for some of its outstanding stock. 6/

6/ One recent form of leveraged recapitalization involves an exchange of stock for "unbundled stock units," each consisting of (i) a 30-year bond, paying interest equal to regular cash dividends being paid on the common stock at the time of the exchange, (ii) an "incremental dividend preferred share," paying a dividend equal to any increase in dividends paid on the common stock and (iii) an "equity appreciation certificate," allowing the holder to buy a share of common stock after 30 years at a price equal to the value of the other two securities at that time. "Market Place: A Plan to Divide Stock into 3 Parts," The New York Times, Dec. 5, 1988, p. D8, Col. 1.

- Repurchases by a corporation of its own stock with borrowed cash. 7/

- Extraordinary distributions, i.e., distributions in amounts greater than the corporation's normal, periodic dividends. The distributions may consist of borrowed cash or of debt instruments.

All these types of transactions result in increases in corporate debt and corresponding decreases in corporate equity. The increased levels of corporate debt, at the expense of equity, resulting from these transactions tend to increase interest deductions and so reduce corporate tax collections. Because all these transactions raise similar tax concerns, any tax steps taken with regard to leveraged buyouts should focus on these transactions as well. Thus, as used in this Report, the term "LBO" is intended to include all these types of transactions, as well as actual leveraged buyouts.

To a large extent, the revenues lost as a result of increased corporate interest deductions would appear to be recovered from investors, because the interest is generally taxable to the investors at the same time as it is deductible to the corporate borrower. On the other hand, unless the investor is itself a corporation, the tax rate applicable to the investors may be lower than the corporate rate. 8/ Furthermore, some investors in corporate debt instruments may not pay income tax (e.g., tax-exempt and foreign investors). 9/ To this extent, tax on the interest income will not completely offset the tax saving to the corporate borrower resulting from interest deductions.

LBOs also may produce additional tax revenues. For example, shareholders of a corporation acquired in an LBO often receive a premium for their stock, and so they may report substantial capital gains. Similarly, an LBO in the form of a leveraged recapitalization or a debt-financed stock repurchase or extraordinary dividend may result in capital gain or

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7/ These stock repurchases may take a variety of forms, including programs to purchase stock on the open market, "self-tenders" by the corporation for its own stock and distributions by the corporation of transferable "put" rights entitling shareholders to sell their stock to the corporation at a fixed or formula price.

8/ Individual investors generally pay tax on both interest and dividend income at rates up to 28 percent (although, in some limited instances, marginal rates may be higher). Corporate investors pay tax on interest income at rates up to 34 percent. Because of the dividend received deduction, their effective tax rate on dividend income generally does not exceed 10.2 percent (although, beginning in 1990, corporations paying the alternative minimum tax may pay an effective 15.25 percent tax on dividends received). Dividend income received by corporations may be taxed again, if it is distributed as dividends to shareholders of the investor corporation.

9/ Other investors not paying full tax on interest income include life insurance companies (to the extent the income is allocated to policy holders), taxpayers with net operating loss carryovers and taxpayers with excess portfolio interest deductions.

dividend income to the shareholders. 10/ Further, after these transactions corporations may seek to reduce leverage by selling major business operations, subsidiary stock or other assets. These sales typically result in immediate taxable gain to the corporation itself, at times without any offsetting increase in the tax basis of the assets in the hands of the buyer. 11/

Treasury Secretary Brady has testified before the Senate Finance Committee that "recent legislative changes may have diminished the tax benefits available from leveraged acquisitions." 12/ He mentioned the reduction in corporate tax rates and the repeal of the General Utilities doctrine in this regard. As practitioners, however, we have observed that the "inversion" of corporate tax rates (34 percent) and individual tax rates (28 percent) in the 1986 Tax Reform Act tends to encourage corporations to substitute debt for equity and thereby achieve taxation of earnings at the lower individual rate. In other words, the current income tax system, with its double tax on corporate earnings and higher corporate rate, appears to push corporations toward greater leverage.

In view of all these elements, we cannot reach a conclusion as to whether the taxes paid as a result of these transactions in the aggregate exceed the revenue losses resulting from increased interest deductions to the corporations. 13/

One final point needs to be emphasized: Not all corporate borrowing reduces corporate equity. Borrowing in LBO-type transactions does, because these transactions involve corporate distributions either at the time of the transaction itself (as in stock repurchases and extraordinary

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10/ As with interest income, a portion of this income or gain may not be taxable. Some of the shareholders may be tax-exempt or foreign investors, and others may have a high basis in their stock (such as those who recently inherited the stock from a decedent).

11/ Before enactment of the Revenue Act of 1987, corporations at times could sell the stock of consolidated subsidiaries with little or no tax. Section 10222 of the 1987 Act reduced the tax basis in the stock of consolidated subsidiaries to prevent a double benefit from certain depreciation deductions. Section 10223 eliminated other planning techniques (generally referred to as "mirror transactions") which had reduced or eliminated the tax on sales of the stock of recently-acquired subsidiaries. The Internal Revenue Service has announced that it will amend the consolidated return regulations in further efforts to discourage such tax planning techniques. See Notice 87-14, 1987-1 C.B. 145; Notice 89-37, 1989-13 I.R.B. __.

12/ Leveraged Buyouts and Corporate Debt: Hearings before Senate Committee on Finance, 101st Cong., 1st Sess. (January 24-26, 1989) [hereinafter cited as SFC Hearings], (Statement by Nicholas F. Brady, Secretary of the Treasury). See also HWMC Hearings (Statement by Nicholas F. Brady).

13/ For methodology to determine whether a particular LBO produces net revenue gain or loss, see Gravelle, Tax Aspects of Leveraged Buyouts, CRS Report for Congress (March 2, 1989).

distributions) or later (upon repayment of the debt issued in a leveraged recapitalization or takeover). On the other hand, much corporate borrowing increases the gross assets of a corporation without reducing corporate equity. One example involves borrowing to acquire new equipment or to build new factories, warehouses and the like. Borrowing to acquire existing productive assets (other than subsidiary stock) similarly does not reduce corporate equity. In our view, any tax legislation intended to respond to LBO activity should focus on debt which reduces equity.

III. Integration of the corporate and shareholder income taxes could reduce the tax incentive to convert debt to equity.

A. Reducing the disparity in tax treatment of corporate debt and equity

The disparity in the tax treatment of corporate debt and equity creates substantial incentive for corporations to borrow. This disparity could be addressed by denying corporations the ability to deduct interest. Such an approach, however, would increase the amount of corporate earnings that are subjected to two levels of income tax and so would widen the gap between the tax treatment of corporate and noncorporate businesses.

Alternatively, the disparity in the treatment of corporate debt and equity could be eliminated or reduced through integration of the corporate and shareholder taxes. 14/ We prefer this approach on grounds of both fairness and efficiency. 15/ Integration of corporate and shareholder income taxes, if properly carried out, would eliminate or reduce two disparities in tax treatment -- one between corporate debt and equity and the other between corporate and noncorporate business income. We note that virtually all of our major industrialized trading partners, including Canada, the United Kingdom, France and Japan, have adopted partially integrated systems for taxing corporate income.

B. Proposals to integrate corporate and shareholder taxes

Over the years, a variety of proposals to integrate corporate and shareholder income taxes have been made. Most of these proposals have been directed primarily at reducing the disparity in tax treatment between corporate and noncorporate income, not the disparity in tax treatment between corporate debt and equity. Although these two goals are not antithetical, some integration proposals would be more effective than others in reducing the disparity between debt and equity. In this Report, we will not recommend any

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14/ In recent testimony before the Senate Finance and House Ways and Means Committees, Treasury Secretary Nicholas F. Brady, Chairman of the Federal Reserve Alan Greenspan, Securities and Exchange Commission Chairman David S. Ruder and other witnesses have favored some form of full or partial integration to offer relief from the double taxation of dividends. *See* SFC Hearings; HWMC Hearings.

15/ *See* American Bar Ass'n Section of Taxation, Comm. on Integration, *Analysis of Treasury Tax Reform Proposals*, April 19, 1985.

particular integration proposal. Rather, we will discuss some of the more well-known integration proposals, with particular focus on their effect that implementation of such proposals would have on the disparity between corporate debt and equity. The proposals discussed in this Report are the following:

- The corporate income tax rate could be reduced, or the corporate tax could be repealed.
- Corporate income could be passed through to shareholders.
- The tax on dividends received could be reduced or eliminated.
- A partial or complete corporate dividend-paid deduction could be adopted.
- A nonrefundable shareholder credit for some or all corporate taxes paid could be adopted.

1. Reduction or repeal of corporate income tax

One integration proposal would involve a reduction in the corporate tax rate or even outright repeal of the corporate income tax. This type of change would eliminate or reduce the tax differences between corporate debt and equity, since corporate interest deductions would become less important as the corporate rate was reduced. Such a change also would generate tax policy concerns, however. Corporate income would not be taxed until distributed. Thus corporations could become tax shelters for accumulating income from business and investment activities. One unfortunate consequence of such a system could be the need for increased use of the accumulated earnings tax and the personal holding company tax provisions to prevent abuse of tax-free accumulations of corporate income.

2. Passthrough of corporate income to shareholders

Another integration proposal would eliminate the separate corporate tax but would require corporate income to pass directly through to shareholders as earned, as in a partnership or S corporation. This system would conform the tax treatment of corporate and noncorporate business. Such a system also would conform the treatment of corporate debt and equity to some extent, in that the income from each type of investment would be taxed only once, to the investor. On the other hand, holders of debt would be taxed only on interest income paid or accrued, whereas stockholders would be taxed on retained as well as distributed corporate income. The difficulty of tracing income of a widely-held corporation to its shareholders could make such a system unworkable. The administrative problems encountered by publicly-traded partnerships illustrate the difficulties of income tracing among large numbers of investors. Finally, such a system would require Congress to make a series of difficult judgments concerning the availability to shareholders of corporate losses and credits and the treatment of tax preferences generated by corporate activities.

3. Elimination of tax on dividends received

The income tax on dividends received by shareholders could be eliminated, in whole or in part. Such a change would eliminate the double tax, but different persons would be taxed on the two different types of income. That is, the corporation but not the investors would be taxed on income from equity, whereas the investors but not the corporation would be taxed on income from debt. Thus, to the extent differences in the corporate and individual tax rates remain, debt and equity would continue to be treated differently.

A recently-proposed variation on this system would eliminate the tax to investors on both dividends and interest and would also eliminate the corporate deduction for interest -- either all interest or interest on certain types of debt instruments. 16/ This variation would conform the tax treatment of corporate debt and equity. Unless the rate differential between corporate and noncorporate taxpayers were eliminated, however, there would continue to be a disparity between the tax treatment of corporate and noncorporate businesses.

4. Dividend-paid deduction

If a deduction for dividends paid were adopted, dividends would be treated much like interest from a tax standpoint, and so the tax advantage of debt over equity would be reduced. 17/ A dividend-paid deduction also has the advantage of being relatively simple to implement and phase in. Indeed, the House of Representatives has already adopted this type of provision. 18/ It should be noted, however, that the adoption of a dividend-paid deduction could increase the amount of corporate income not subject to tax, to the extent dividends are paid to tax-exempt and foreign investors. Any proposal to change this result should take into account policies relating to national pension and welfare benefits, charitable organizations and foreign investment in the United States.

16/ L. Bravenec, A Non Traditional Approach to Integration of the Corporation and Shareholder Income Taxes (Feb. 15, 1989) (unpublished article). Under this proposal corporate payors would not be entitled to deductions for dividends or interest, and investors would not be taxed on receipt of such payments. This approach could apply to only a proportion of dividends and interest. Also, interest on certain types of debt, such as debt owing to banks and thrift institutions, could remain deductible.

17/ Differences between debt and equity might remain. For example, under current law dividends generally are taxed only when paid, whereas interest generally is taxed to the lender and is deductible to the borrower as it accrues, whether or not it is paid. Rules pertaining to original issue discount and the like permit deduction of interest before it is paid.

18/ In 1985 the Administration proposed a corporate deduction for 10 percent of dividends paid out of earnings that had borne regular corporate income tax. The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity ("Treasury II"), Chapter 6.02. The House-passed version of what became the Tax Reform Act of 1986 contained a similar provision, to be phased in over several years. Section 311 of H.R. 3838 as passed by the House of Representatives on December 17, 1985.

5. Shareholder credit for corporate tax paid

Perhaps the most promising proposal to integrate the corporate and shareholder income taxes in the long term would involve a shareholder credit for corporate taxes paid. Under such a system, the corporation itself would continue to be taxed on its income, net of interest. Shareholders would be taxed on the amount of dividends received, with the taxable amount being increased, or "grossed up," by the amount of corporate tax attributable to the income distributed. The shareholders also would be eligible for a nonrefundable credit equal to the same amount of corporate tax. Tax-exempt investors would not be able to use the credit. Presumably, however, withholding on dividends paid to foreign shareholders would be based on the "grossed up" amount of the dividend, and the credit would be available to offset withholding. As a result, net corporate income would be taxed at least once, to the corporation. As under current law, however, income paid out as interest would be taxed only to the recipient and would not be taxed at all when paid out to tax-exempt and certain foreign investors.

As described above, this type of integration would help conform the tax treatment of corporate and noncorporate income but not necessarily the tax treatment of corporate debt and equity. To eliminate the difference in treatment of debt and equity, it would be necessary either (i) to impose a tax on interest income of tax-exempt and foreign investors or (ii) to deny the corporate deduction for at least certain interest, and to extend the credit to recipients of such interest as well as dividends. 19/ In part V of this discussion, below, consideration is given to certain implications of these alternatives for national policies pertaining to funding of pension and welfare benefit obligations, to charitable organizations and to foreign investment in the United States.

C. Conclusion

Integration of the corporate and shareholder income taxes would have many benefits, and it is a worthwhile goal for tax reform. Integration would help conform our tax system with the systems of our major trading partners and could also eliminate or reduce arbitrary differences between the tax treatment of debt and equity investments and between business conducted in corporate and noncorporate forms.

We acknowledge, however, that integration would likely involve significant revenue loss. 20/ Integration also would

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19/ In his statement delivered to the Senate Finance Committee, Professor Michael J. Graetz of the Yale Law School proposed a tax on net corporate income, with no corporate interest deduction and with a credit for tax paid by the corporation being made available to recipients of both interest and dividends. SFC Hearings (Statement of Michael J. Graetz).

20/ In November 1984 the Treasury Department issued a report to the President which included a proposal for a phased-in 50% dividend-paid deduction. The revenue cost of the fully phased-in provision was estimated by Treasury at $31 billion for fiscal year 1990. "Tax Reform For Fairness, Simplicity and Economic Growth, The Treasury Department Report to the President ("Treasury I"), Volume I" 118, 238 (November 1984).

require basic changes to the tax system with impact far beyond LBOs. Consequently, if Congress wishes to move quickly in response to LBO activity, comprehensive integration may not be practical. Nevertheless, a limited form of integration, such as a partial shareholder credit for corporate taxes paid or a deduction for a portion of dividends paid, if properly implemented, would be an appropriate step toward reducing the differences between the tax treatment of corporate debt and equity.

IV. Partial disallowance of interest deductions, targeted at certain debt, could offset any revenue loss resulting from integration.

As noted above, there may be revenue losses from partial integration of corporate and shareholder taxes. Any such revenue losses could be offset by some form of restriction on the corporate interest deduction. If properly designed, such a restriction could also reduce the disparity in the tax treatment of debt and equity.

Several types of restrictions on the corporate interest deduction have been suggested:

- All or a fixed portion of corporate interest expense could be made nondeductible.
- A maximum permissible debt-equity ratio could be established on an industry-by-industry basis.
- Interest deductions could be disallowed on instruments that bear interest at a rate exceeding a maximum rate based on an index.
- Limitations could be placed on the interest deduction for debt incurred in connection with LBO transactions.
- Interest deductions could be disallowed on "equity flavored" corporate debt.

A. Disallowance of interest deduction generally

Corporations could be prohibited from deducting any interest or a ratable portion of all their interest. [21] Such a general disallowance of the interest deduction should result in a decrease in LBO activity and an increase in federal tax revenues.

At the same time, since corporate interest is a cost of doing business, general disallowance of the corporate interest deduction is inconsistent with a tax on net income, rather than gross income. Moreover, a general disallowance could have serious repercussions throughout the economy. Certain businesses would be especially hard-hit. Examples of such businesses include those which depend on debt to finance inventory, as well as banks and public utilities. Public utilities typically borrow substantial sums for construction, and, if interest were not deductible, rates to consumers would have to be increased. More generally, this type of disallowance would affect borrowing generally, including borrowing to acquire new productive facilities, even though such borrowing does not reduce corporate equity.

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[21] See Bierman, Debt, Stock, and Junk Bonds, Tax Notes, December 12, 1988, p. 1237.

Additionally, taxpayers could be expected to avoid the disallowance rule by leasing or licensing property to corporations, effectively substituting deductible rents or royalties for nondeductible interest. Rules would have to be developed to deter this kind of avoidance.

In short, the "LBO problem" would not be solved by a general disallowance of all or a proportion of the corporate interest deduction. The adverse effects would significantly outweigh the benefits of a decline in LBO activity.

B. Imposition of industry-wide debt-equity ratios

Rather than eliminate the corporate interest deduction entirely or proportionally, Congress could treat corporate debt in excess of specified debt-equity ratios as equity for tax purposes.

Recognizing that historic debt-equity ratios vary widely based on the nature of the business conducted, some observers have proposed that a maximum debt-equity ratio be established for each industry. 22/ If a business exceeded the established maximum, then a portion of its debt would be recharacterized as equity. Complex ordering rules might be required to determine which debt would be treated as equity.

This proposal would require the Treasury Department to determine appropriate debt-equity ratios for every industry, a daunting task and one even more complex for multi-industry companies. In addition, this rule might actually promote takeovers in some instances. Those businesses that were "underleveraged" by industry standards in terms of the maximum permitted ratio would become acquisition targets, because other corporations would wish to avail themselves of the corporation's unused interest deductions.

We do not favor this proposal. It would be very difficult to administer, and it would be unlikely to prove effective in reducing LBO activity quickly.

C. Interest deduction disallowed on instruments bearing interest in excess of a maximum rate

If differences in the tax treatment of debt and equity are to be maintained, it is important to identify the nature of each interest in a business. To the extent stated return accurately reflects the degree of risk, that return may distinguish debt from equity. A substantial part of the debt frequently issued in connection with LBOs bears a high rate of return. It may be appropriate to treat such debt as equity for tax purposes.

Under such an approach, a debt instrument that bears interest at a rate higher than a maximum rate, set by reference to an index, would be treated as equity for tax purposes. For example, an indexed rate could be set several percentage points

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22/ See Canellos, The Over-Leveraged Acquisition, 39 The Tax Lawyer 110 (1985).

higher than the "applicable Federal rates" as defined in section 1274(d). 23/

Imposition of a maximum rate of deductible interest may have a significant adverse impact on small businesses and on start-up or risky ventures. This problem could be partially solved, as to small corporations, by adding a floor permitting, for example, $5 million of interest deductions per year without regard to the maximum rate.

Even if the problem of small corporations were solved, we still would have concerns about this proposal's effect on start-up and other risky ventures. Specifically, a disallowance of interest deductions based solely on the interest rate would ignore a variety of other equally important terms of the debt instrument, as well as the business exigencies and purposes precipitating the borrowing. As a consequence, this type of interest deduction disallowance could fail to reach instruments that appropriately could be regarded as equity, while at the same time subjecting to the disallowance rule other instruments appropriately regarded as debt.

D. Restrictions on deductions for interest on debt incurred for LBO purposes

To halt the conversion of equity to debt in the context of LBOs, Congress could restrict the availability of an interest deduction in connection with LBO-type transactions. Section 279A, as contained in section 10138 of H.R. 3545, as passed by the House of Representatives in 1987, and H.R. 158, the "Corporate Raider Tax Act of 1989," are examples of proposals for such restrictions on the interest deduction.

1. Section 279A approach

Section 279A would have limited the deduction for interest on certain stock acquisition indebtedness to $5 million per year. Section 279A would have applied to any "major stock acquisition," defined as the acquisition of 50 percent or more of the vote or value of a target corporation's stock. All acquisitions within a three-year period would have been treated as part of a single plan.

Under section 279A, interest expense would have been subject to disallowance, if the indebtedness were incurred or continued in connection with an acquisition, or if the indebtedness were allocable to stock acquired in an acquisition. The allocation was to be based upon the ratio of the adjusted basis of the stock acquired to the adjusted basis of the assets of the acquiring corporation. Interest expense incurred more than five years after the acquisition, however, was not to be subject to disallowance. 24/

23/ A variation on this proposal would disallow a deduction for only that amount of interest that exceeded a maximum rate.

24/ Senator Terry Sanford recently has proposed a narrowed section 279A-type approach, aimed at LBOs involving large amounts of debt incurred by the acquired corporation. S. 325, introduced by Senator Sanford on February 2, 1989, would disallow corporate interest deductions in the same manner as section 279A, except that the disallowance would apply only if

(Footnote Cont'd)

Section 279A would not have applied to asset acquisitions or to stock acquisitions if a section 338 election were made. Nor would section 279A have affected the tax deduction for contributions to an ESOP used to pay principal and interest on acquisition indebtedness incurred by the ESOP. Some or all of these exclusions may not be appropriate, if there is concern with the long-term economic effects of leverage and the erosion of the corporate tax base.

There are advantages to the section 279A-type approach. First, as in section 279A itself, the disallowance could be made applicable only to interest expense in excess of a floor amount, so as to exempt small and medium-sized acquisitions. Second, such a disallowance would directly target interest incurred in at least some transactions that substitute debt for equity. The relatively narrow focus of such an approach would make it less likely that transactions not intended to be covered would be reached, while assuring that most transactions intended to be covered would be reached. If this type of approach is adopted, however, it should be extended to other debt which is substituted for equity.

We recognize that there may be difficulties in drafting provisions that will not give rise to opportunities for avoidance. We believe, however, that these difficulties can be overcome.

Finally, the impact of a section 279A-type rule would likely be more significant for a domestic purchaser than for a foreign purchaser. So long as a foreign purchaser could deduct interest costs arising from the acquisition in its country of residence, denial of a U.S. interest deduction may not be a material concern to that foreign acquirer. Thus, a section 279A-type approach might favor foreign ownership of U.S. businesses. 25/

24/ (Footnote Cont'd From Previous Page)

the acquired corporation's debt-to-equity ratio immediately after the acquisition (1) exceeds 3 to 1, and (2) is at least 50% higher than immediately before adoption of the acquisition plan.

25/ In making changes with respect to deductibility of interest expense, either a broad-based disallowance or a targeted one, consideration should be given to the fact that foreign acquirers who are income taxpayers in non-U.S. jurisdictions often have a choice of financing the acquisition outside the United States and deducting the interest in non-U.S. jurisdictions or financing the acquisitions in the United States and deducting the interest expense here. Imposition of limitations on deductibility of acquisition interest expense in the United States may give foreign acquirers a competitive advantage over U.S. acquirers because the foreign acquirers may be able to maintain full deductibility of their acquisition interest expense by incurring a greater proportion of their acquisition debt outside the U.S. and placing correspondingly less acquisition debt inside the target corporation. Some of this advantage may be offset, however, by withholding taxes imposed by the United States on dividends paid to foreign shareholders and by foreign taxes imposed on such dividends.

2. Corporate Raider Tax Act approach

The "Corporate Raider Tax Act of 1989," H.R. 158, would limit the deductibility of interest on debt incurred or continued to purchase or carry the stock or assets of a corporation acquired in a "hostile qualified stock purchase." The acquirer would also be treated as having made an election under section 338, resulting in an immediate tax liability to the target.

Under this proposal, the tax consequences of a transaction would depend, not on the substance of the transaction, but on whether independent directors of a target company accept an offer. In our view, this distinction is not appropriate. Friendly and hostile takeovers should be taxed in the same manner. To the extent distinctions should be made between these types of takeovers, these distinctions should be made in the securities laws or in state corporate laws and not in the Internal Revenue Code.

E. Interest deduction disallowed on "equity flavored" debt

As long as the distinction between the treatment of debt and equity remains significant for tax purposes, it is important to identify properly each type of interest in a business. Certain types of interest in businesses have characteristics of both debt and equity. It may be appropriate, particularly in the context of restricting LBO activity, to treat interest on certain hybrid or "equity flavored" instruments as nondeductible. 26/ "Equity flavored" debt might be defined as debt having equity characteristics such as (i) participation in earnings or appreciation, (ii) an absence of current actual payments of interest or (iii) payments not in the form of cash.

Under this approach, interest on "straight debt" would be deductible, but the following types of "interest" could be treated as distributions with respect to stock:

- Interest contingent on either current earnings or property appreciation.
- Interest on zero coupon and other original issue discount obligations with a term of more than three years.
- Interest payable in-kind rather than in cash (*e.g.* "baby bonds").

This approach would not require evaluation of debt-versus-equity factors or a determination of whether the payor is "over-leveraged." The approach could apply to interest received from non-corporate as well as corporate payors.

Because the proposal would affect debt of a type issued frequently in connection with LBOs but less often in other contexts, the proposal may reduce the tax incentive for LBO transactions without adversely affecting other types of activities. The proposal could, however, have an adverse impact on venture capital transactions.

26/ See HWMC Hearing (Statement by Martin D. Ginsburg; Statement by Jack S. Levin).

V. Tax-exempt and foreign investors must be considered.

In recognition of the social benefits they provide, charities, retirement funds and other tax-exempt entities, traditionally have not paid tax on their investment income. Similarly, to encourage foreign investment in the United States, foreign investors are permitted to receive interest from U.S. corporations free of U.S. tax in certain circumstances. As a result, corporate earnings paid to these investors in the form of interest are not subject to U.S. income tax at either the corporate level or the investor level. Moreover, to the extent that tax-exempt and foreign investors add to the demand for corporate debt instruments, U.S. corporations have added incentive to substitute debt for equity.

This situation could be addressed in either of two ways: First, a tax could be imposed on all or certain types of interest income received by tax-exempt or foreign investors. Second, the disparity between debt and equity at the corporate level could be eliminated or reduced.

The first alternative, a tax on all or certain types of interest income received by tax-exempt or foreign investors, would represent a major shift in tax policy. Such a shift should not be entertained without careful consideration of overall national policies relating to charitable organizations, retirement funding and foreign investment in the United States. Further, a significant percentage of tax-exempt investment in LBOs is held by pension plans maintained by state and local government instrumentalities, the taxation of which could raise constitutional issues. Similarly, a tax on foreign investors would complicate treaty negotiations and could have an adverse impact on international relations. For these reasons, we do not generally favor changes which directly affect tax-exempt and foreign investors.

The second alternative, reducing the disparity between debt and equity at the corporate level, seems preferable to us. Such an approach could involve interest and dividends paid to all investors, including tax-exempt and foreign entities. For example, partial integration of the corporate and shareholder income taxes, combined, if necessary, with a partial disallowance of deductions for LBO interest, could affect interest and dividends paid regardless of the recipient's tax status. The result would be a reduction in the disparity between debt and equity at the corporate level. Such a system also would be relatively easy to administer, because it would focus only on corporate taxpayers. There would be no direct impact on the status of tax-exempt or foreign investors, although, under some types of integrated systems, these investors could be required to bear indirectly a new or increased tax burden.

CONCLUSION

This is the appropriate time to begin serious consideration of an integrated system of taxing corporate and shareholder earnings. Economic inefficiencies resulting from our present two-tier system could be eliminated or substantially reduced by implementing such a system. Congress should consider a limited form of integration, coupled, if necessary, with a targeted disallowance of deductions for interest on debt incurred in connection with LBOs and similar transactions. This approach would discourage the conversion of corporate equity into debt without hampering desirable economic activity.

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Chairman ROSTENKOWSKI. Thank you, Mr. Treiger.
Mr. Hoffman.

STATEMENT OF ARTHUR S. HOFFMAN, CHAIRMAN, EXECUTIVE COMMITTEE, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOMPANIED BY PAUL SCHECTER, CHAIRMAN OF THE CORPORATIONS AND SHAREHOLDERS TAXATION SUBCOMMITTEE

Mr. HOFFMAN. Thank you, Mr. Chairman. I am Arthur S. Hoffman, chairman of the executive committee of the Federal tax division, American Institute of CPA's, and joining me is Paul Schecter, chairman of our subcommittee on corporations and shareholders.

The AICPA is the national, professional organization of CPA's, with over 280,000 members. Many of our members are tax practitioners who work with millions of American taxpayers, both individual and business.

We are deeply concerned with tax policy matters and certainly with proposals, such as these, to change the Internal Revenue Code in ways which will have an impact upon businesses of all sizes in all sectors of the economy.

We do not express an opinion on whether highly leveraged transactions should be restricted as a matter of public policy. We are testifying for the purpose of offering our strong recommendation that if Congress chooses to restrict such transactions, the tax law should not be employed to accomplish the task. We believe that any attempt to tailor the Internal Revenue Code to thwart debt-financed acquisitions will be ineffective, will have unintended results, and will cause grave problems for American taxpayers, and tax practitioners and the Internal Revenue Service.

Specifically, we have the following concerns.

Complexity. The complexity added to the tax law will defy compliance and enforcement.

The scope. The practical difficulties of identifying the targeted transactions are immense. In addition, any simple tactic, such as a blanket disallowance of a deduction for interest, will impact the wrong targets.

Efficiency and effectiveness. In the area of mergers and acquisitions, the tax law has frequently proven to be an inefficient and ineffective vehicle to discourage the use of highly leveraged transactions.

And favoritism. Foreign purchasers not subject to restrictive U.S. tax laws will be accorded further advantage over their American competitors.

In the balance of this testimony, I will explain these summary points.

On complexity, highly leveraged transactions of which there are many varieties cannot be thwarted by the passage of simple provisions.

To aim a tax provision at a selected target in a landscape of complex and changeable financial structures will require a highly detailed statute and/or lengthy regulations involving a long drafting period. This drafting period will then be followed by the slow development of case law to resolve the inevitable issues.

Some perception may exist that complexity can be diminished by disallowing interest deductions on a broad scale, such as by disallowing a fixed percentage of the interest expense of every business, large or small. This simplistic approach lacks any semblance of equity, particularly with respect to many businesses in every local community throughout the country which are required to rely on debt to carry their inventory and receivables and payroll to continue operating.

As to the scope of application, businesses which borrow to operate and produce taxable income should not have their cost of capital increased by a general disallowance of interest deductions.

Congress would face a major challenge in determining the appropriate transactions to condemn. Some propose denying interest deductions in cases of "hostile" takeovers out of concern for abusive tactics on the part of the raider or management, or both. Others propose denial in all mergers and acquisitions out of fear of the growth of corporate debt, and still others recommend that a deduction be denied only if the interest rate exceeds certain acceptable levels, a result of a dislike of "junk bonds."

We believe that it is for Congress to decide what aspect of these transactions it perceives threatens our economic system. Once Congress makes its decisions, we recommend that it address only those transactions which contribute to that threat. However, we acknowledge that in making its selection of a target, Congress will unavoidably permit the recasting of transactions into alternative forms, and that would bring us back to the complexity issue.

In addition to addressing the form of the transaction, the magnitude of the transaction should be considered. After all, does Congress wish to prevent the local grocer from buying the store of his neighbor who wishes to retire?

As to efficiency and effectiveness, the policy determination of the scope of a tax provision fixes its technical boundaries. In the case of highly leveraged transactions, these boundaries will be subject immediately to penetrating analysis to determine how transactions can be structured, so that the next wave of leveraged buyouts and mergers and acquisitions can proceed unabated.

It is obvious to the casual observer that the incredible number and size of recent acquisitions demonstrates that tax law provisions adopted heretofore over the years to discourage such activities have not been effective.

Consider the range of a few of these provisions: Repeal of the general utilities doctrine causing recognition of gain at the corporate level; limitation under section 279 of the deductibility of interest incurred to acquire another corporation's stock or assets; the omnipresent section 385, which establishes the factors to be used to determine what is debt and what is equity; and the denial of deductibility of so-called golden parachutes under section 280G. There are, of course, others.

The AICPA does not believe that it can be demonstrated that any additional amendment of the Internal Revenue Code, designed to prevent further merger and acquisition activity, will be more efficient and effective than the previous attempts.

As to favoritism of foreign purchases—use of the tax law to control financial activities penalizes those who are subject to it and gives a competitive advantage to those who are not. Acquisitions of U.S. companies by foreign buyers can be structured so that the impact of U.S. tax law is neutralized for them.

In recent years, acquisition of U.S. businesses has become an international sport. In the frequently intense competition for a takeover target, the American participant clearly would be handicapped by use of the tax law if Congress chooses it to restrain highly leveraged transactions. The U.S. entry would have a greater weight to carry, and the foreign entry would have a shorter course to run.

As to specific tax proposals that you have seen, Congress has received an excellent study prepared by the staff of the Joint Committee led by Ronald A. Pearlman, entitled "Federal Income Tax Aspects of Corporate Financial Structures." The study sets forth eight different mechanisms to eliminate or reduce the distinction between debt and equity. The emphasis of the study is to place limits upon the deductibility of interest.

We have analyzed the eight proposals and conclude that in each, in varying degrees, the problems described earlier in this testimony—complexity, proper scope, efficiency and effectiveness, and favoritism are unavoidably present. Consequently, we recommend again that if any action is deemed necessary, Congress should explore all non-tax approaches before employing tax legislation to address the problem.

However, if Congress does decide that some limit on interest deductions must be adopted, we believe that one of the eight proposals has greater potential than the others. The proposal is captioned, "Limit interest deductions in certain transactions where debt supports a distribution of corporate equity, unless corporate level tax is paid on corporate asset appreciation." That is one of the eight.

This approach would be complicated and would require the tracing of borrowed funds. As we said previously, 6 tax law changes which do have the proper scope necessarily will add complexity. However, we think that the provision is less subject to the problems we have described than are the other seven proposals.

We did note with great interest that the report also states that the favoritism of debt over equity can be addressed through more closely aligning the tax treatment of dividends and interest. The method described is the partial or complete integration of the corporate and individual income tax systems. The AICPA, in 1976, issued statement of tax policy No. 3, "Elimination of the Double-Tax on Dividends." It remains to this day the official policy of the AICPA that some form of integration of the corporate and individual tax systems is desirable. We believe that integration is a better way to eliminate the favoritism accorded debt than denial of interest deductions.

In conclusion, Mr. Chairman, the AICPA has repeatedly recommended to Congress in oral and written testimony and position papers that there must be a respite from changes in the tax law.

Now a whole new set of proposals is being considered with respect to an expense—interest—which is integral to the earning capacity of businesses throughout the country. There are perceived abuses in the economic environment with transactions which generate interest deductions, and the tax law, once again, is being considered as a tool to exercise control.

We urge Congress to consider the problems we anticipate will arise as a result of denying, in whole or in part, the deduction for interest, and we ask members of the committee to recall their own declarations that simplification of the Internal Revenue Code is now a critical goal.

Thank you, Mr. Chairman.

[The statement of Arthur S. Hoffman follows:]

STATEMENT OF ARTHUR S. HOFFMAN

on Behalf of the
American Institute of Certified Public Accountants

INTRODUCTION

I greatly appreciate this opportunity to offer comments and recommendations prepared by the Federal Tax Division of the American Institute of Certified Public Accountants on the tax policy aspects of leveraged buyouts, mergers and acquisitions. I am Arthur Hoffman, Chairman of the Executive Committee of the Federal Tax Division of the American Institute of Certified Public Accountants.

The AICPA is the national, professional organization of CPAs, with over 280,000 members. Many of our members are tax practitioners who work with millions of American taxpayers: individual and business. We are deeply concerned with tax policy matters, and certainly with proposals to change the Internal Revenue Code in ways which will have an impact upon businesses of all sizes, in all sectors of the ecomony.

We have been close observers of the proliferation of corporate restructuring. The statistics demonstrate that the use of debt as opposed to equity has become the method of choice in financing corporate acquisitions.

We do not express an opinion on whether highly-leveraged transactions should be restricted as a matter of public policy. We are testifying for the purpose of offering our strong recommendation that, if Congress chooses to restrict such transactions, the tax law should not be employed to accomplish the task. We believe that any attempt to tailor the Internal Revenue Code to thwart debt-financed acquisitions will be ineffective, will have unintended results and will cause grave problems for American taxpayers, tax practitioners and the Internal Revenue Service. Specifically, we have the following concerns:

- Complexity.

  The complexity added to the tax law will defy compliance and enforcement.

- Scope.

  The practical difficulties of identifying the targeted transactions are immense. In addition, any simple tactic, such as a blanket disallowance of a deduction for interest will impact the wrong targets.

- Efficiency and Effectiveness.

  In the area of mergers and acquisitions, the tax law has frequently proven to be an inefficient and ineffective vehicle to discourage the use of highly leveraged transactions.

- Favoritism.

  Foreign purchasers not subject to restrictive U.S. tax laws, will be accorded an advantage over their American competitors.

In the balance of this paper, we will explain these summary points.

General Comments on Tax Law Proposals

Complexity.

Highly leveraged transactions, of which there are many variations, cannot be thwarted by the passage of simple provisions. To aim a tax provision at a selected target, in a landscape of complex and changeable financial structures, will require a highly detailed statute and/or lengthy regulations involving a long drafting period. This drafting period will then be followed by the slow development of case law to resolve the inevitable issues.

Furthermore, any provisions will be made more complex if Congress chooses to exempt small buyers or small transactions. Yet logic dictates that some exemption be granted to smaller parties and transactions so that the vital growth of developing businesses will not be inhibited.

Complexity will be added also if Congress prescribes that borrowed funds must be traced to determine if they are used to make disfavored acquisitions. However, it appears essential to require such tracing to avoid disallowing interest on borrowings for regular business operations.

Some perception may exist that complexity can be diminished by disallowing interest deductions on a broad scale, such as by disallowing a fixed percentage of the interest expense of every business, large or small. This simplistic approach lacks any semblance of equity, particularly with respect to many businesses in every local community throughout the country which are required to rely on debt to carry their inventory, receivables, and payroll to continue operating.

Scope of Application

We believe that provisions arising out of Congressional intent to discourage highly leveraged acquisitions should be designed to serve that express purpose. Businesses which borrow to operate and produce taxable income should not have their cost of capital increased by a general disallowance of interest deductions.

Congress would face a major challenge in determining the appropriate transactions to condemn. Some propose denying interest deductions in cases of "hostile" takeovers out of concern for abusive tactics on the part of the raider, management, or both; others propose denial in all mergers and acquisitions out of fear of the growth of corporate debt; and still others recommend that a deduction be denied only if the interest rate exceeds certain acceptable levels, a result of a dislike of "junk bonds."

We believe that it is for Congress to decide what aspect of these transactions it perceives threaten our economic system. Once Congress makes its decisions, we recommend that it address only those transactions which contribute to that threat. However, we acknowledge that in making its selection of a target, Congress will unavoidably permit the recasting of transactions into alternative forms.

In addition to addressing the form of the transaction, the magnitude of the transaction should be considered. After all, does Congress wish to prevent the local grocer from buying the store of his neighbor who wishes to retire?

Also, it should be noted that in almost all situations, attempts by Congress to limit the scope of application of tax law provisions have created additional complexity and frequently made the provision less efficient and effective.

Efficiency and Effectiveness

The policy determination of the scope of a tax provision fixes its technical boundaries. In the case of highly leveraged transactions, these boundaries will be subject immediately to penetrating analysis to determine how transactions can be structured so that the next wave of leveraged buyouts, mergers, and acquisitions can proceed unabated.

Even the establishment of a de minimis rule, i.e., the exclusion of a dollar amount from the application of a disallowance of interest, will induce the multiplication of entities representing the parties or fractionalization of the transactions themselves.

It is obvious to the casual observer that the incredible number and size of recent acquisitions demonstrates that tax law provisions adopted over the years to discourage such activities have not been effective.

Consider the range of a few of these provisions: repeal of a General Utilities doctrine, causing recognition of gain at the corporate level; limitation under Section 279 of the deductibility of interest incurred to acquire another corporation's stock or assets; the omnipresent Section 385, which establishes the factors to be used to determine what is debt and what is equity; and the denial of deductibility of so-called "golden parachutes" under Section 280G.

Apparently, the provisions were inefficient, i.e. the price of the "abusive" transactions were adjusted for additional costs, if any. The provisions themselves were ineffective in preventing the structuring of deals outside their scope. In each case, the provisions proved inadequate to solve a larger, more compelling problem: the trend towards business combinations for reasons transcending the tax law.

The AICPA does not believe that it can be demonstrated that any additional amendment of the Internal Revenue Code, designed to prevent further merger and acquisition activity, will be more efficient and effective than the previous attempts.

Favoritism of Foreign Purchasers

Use of the tax law to control financial activities penalizes those who are subject to it, and gives a competitive advantage to those who are not. Acquisitions of U.S. companies by foreign buyers can be structured so that the impact of U.S. tax law is neutralized for them.

Foreign companies which borrow abroad to finance acquisitions in the United States can select the most favorable tax climate in which to borrow. Their interest expense may be deductible in the originating country, or, indeed, their profitable enterprise may not be subject to tax. If they lend funds to U.S. subsidiaries to engage in acquisitions, the interest paid to them may be subject to low U.S. tax rates in accordance with treaties. The choices are many for the foreign buyer; the leverage in a highly leveraged transaction can be located in the U.S. or in any one of several hospitable nations.

In recent years, acquisition of U.S. businesses has become an international sport. In the frequently intense competition for a takeover target, the American participant clearly would be handicapped by use of the tax law if Congress chooses it to restrain highly leveraged transactions.. The U.S. entry would have a greater weight to carry; the foreign entry would have a shorter course to run.

Specific Tax Proposals

Congress has received an excellent study prepared by the Staff of the Joint Committee led by Ronald A. Pearlman, entitled Federal Income Tax Aspects of Corporate Financial Structures. This publication is an invaluable guide to the issues created by the increase of corporate debt, and to the several proposals to attack the perceived problems through changes of the tax law.

The report describes the ways that debt financing of transactions is favored over equity financing under our tax system. The study sets forth eight different mechanisms to eliminate or reduce the distinction between debt and equity. The emphasis of the study is to place limits upon the deductibility of interest.

We have analyzed the eight proposals and conclude that in each case, in varying degrees, the problems described earlier in this paper: complexity, proper scope, efficiency and effectiveness, and favoritism are unavoidably present.

Consequently, we recommend again that if any action is deemed necessary, Congress should explore all non-tax approaches before employing tax legislation to address the problem.

However, if Congress does decide that some limit on interest deductions must be adopted, we believe that one of the eight proposals has greater potential than the others. The proposal is captioned: "Limit interest deductions in certain transactions where debt supports a distribution of corporate equity, unless corporate level tax is paid on corporate asset appreciation" (item B.3.b, in Chapter V). This approach would be complicated, and would require the tracing of borrowed funds. As we said previously, tax law changes which do have the proper scope necessarily will add complexity. However, we think that the provision is less subject to the problems we have described, than are the other seven proposals.

We did note with great interest that the report also states that the favoritism of debt over equity can be addressed through more closely aligning the tax treatment of dividends and interest. The method described is the partial or complete integration of the corporate and individual income tax systems. The AICPA, in 1976, issued Statement of Tax Policy No. 3, Elimination of the Double-Tax on Dividends. It remains to this day the official policy of the AICPA that some form of integration of the corporate and individual tax systems is desirable.

We believe that integration is a better way to eliminate the favoritism accorded debt than denial of interest deductions.

Conclusion

The AICPA has repeatedly recommended to Congress, in oral and written testimony and position papers that there must be a respite from changes in the tax law. Taxpayers, in all but the simplest cases, cannot comprehend the taxes to which they are subject. Planning, compliance and enforcement have become problematical for the tax practitioner and Internal Revenue Service. New provisions defy the ability of the revenue estimators.

Now, a whole new set of proposals is being considered with respect to an expense, interest, which is integral to the earning capacity of businesses throughout the country. There are perceived abuses in the economic environment with transactions which generate interest deductions, and the tax law once again is being considered as a tool of government to exercise control.

We urge Congress to consider the problems we anticipate will arise as a result of denying, in whole or in part, the deduction for interest. We ask members of the Committee to recall their own declarations that simplification of the Internal Revenue Code is now a critical goal.

Chairman ROSTENKOWSKI. Thank you, Mr. Hoffman.

Mr. Gibbons.

Mr. GIBBONS. Mr. Hoffman, I agree with you. I do not have a whole lot of questions for you. I agree with you.

I do not see how we are going to do it through the Tax Code. It seems to me the best thing is in the rigorous enforcement of the antitrust laws. Have you all thought about that approach.

Mr. HOFFMAN. Mr. Chairman, I must point out that we are the Tax Division of the AICPA.

Mr. GIBBONS. I understand, but you all must talk a little over coffee or bourbon or something?

Mr. HOFFMAN. Well, over bourbon, I would say it is a better approach to go through the securities laws than it is to go through the Tax Code, because the Tax Code is so general in nature, applies to so many businesses under so many circumstances, that it is difficult to target as we indicated, and it is difficult not to hit other targets that you do not really want to hit, like small business.

If you go through the securities law, you have a much better tailoring process. With the antitrust laws, you have a much better tailoring process, and you can pick your targets.

Mr. GIBBONS. That is all the questions I have, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman.

I appreciate the testimony of both of the witnesses this morning, and I think they make some excellent points.

I got a little bit of an inference from Mr. Treiger's testimony that perhaps it might be acceptable, under some circumstances, to limit the deductibility of interest if properly done, relative to areas of recapitalization.

I hope that that inference was not there in your testimony. But if it was, I would like to ask you to explain why you think that would be workable in equity, taking account of all kinds of different requirements out there in the way of financing corporate activity.

Mr. TREIGER. Mr. Archer, I would like to stress that it is our position that the tax laws should not be tampered with in addressing this problem, if it is a problem. On the other hand, if it is felt that something has to be done, it is our position that integration is the route to travel.

And, if it is thought that the cost of integration is too high, and that there must be something to pay that cost, then and only in that event—if we have to find something—a limited approach toward disallowance of interest might be acceptable, if we could craft one that covered only those transactions that we thought created the problems.

Mr. ARCHER. Well, you see, it troubles me a great deal that you even state that as an alternative. I would like for you to tell me how we can separate what is good interest deductibility from bad interest deductibility—No. 1.

No. 2, for those corporations that cannot effectively acquire equity capital and must borrow, if you limit the deductibility of interest, you are impacting on them in such a way as to make them noncompetitive against other corporations which can borrow. I am surprised that you would even include that as an alternative in your recommendations.

Mr. TREIGER. I think that we need to emphasize that our recommendation, and it really is only an alternative recommendation—is not directed at a general interest disallowance, but only at interest disallowance in the areas of acquisitions subject similar to the 279A provision which was in the House bill a couple of years ago.

Mr. ARCHER. But you mention recapitalization, if I remember your testimony, not just acquisition.

Mr. TREIGER. The only recapitalizations we are talking about are those which result in the substitution of debt for equity.

Mr. ARCHER. Well, Mr. Hoffman, would you like to make any comment? You see, when you make an alternative proposal, even though it is third or fourth in line, many members of the committee might say, "Oh, well, that is OK, because he listed it."

That is what is troubling me. They forget about the fact that you say, first off, that you should not do anything in the Tax Code.

Mr. TREIGER. Mr. Archer, may I say that that thought occurred to all of us as we prepared our position, and there were some in our group who thought that we should delete any alternatives of that type.

On the other hand, we are trying to take a constructive and realistic approach to the problem, and therefore, we thought that if something were to be done, this is the least troubling.

Mr. ARCHER. Mr. Hoffman, do you share that view?

Mr. HOFFMAN. Mr. Archer, I can start and finish by saying that the tax law should not be changed, if that would assist. But we went through the eight proposals, and we found one that to us was less of a problem than the others, and more in line with the nature of the perceived difficulty—the increase of corporate debt. If moneys are borrowed, which are in turn paid out in redemption or special dividends or something of the sort, there is a clear substitution of the debt for the equity.

We figure that there is a tracing problem, but there would be less of a tracing problem. We figure that there would be complexity, but there would be less complexity. So if there are any alternatives that are being sought, that one seems to us to address the clearest of the problems.

Mr. ARCHER. To what degree do you gentlemen—this is my last question—believe that the corporate rate being higher than the individual rate for the first time, I think, in the history of our country, has had an impact on these LBO's?

Mr. TREIGER. In my personal judgment, I think that the inversion of the rates, having a corporate rate that is higher than the individual rate, has been an incentive toward moving toward debt in the corporate level. I have little question about that.

Mr. ARCHER. Do you agree with that, Mr. Hoffman?

Mr. HOFFMAN. Yes, Mr. Archer. The deductibility of interest in the LBO's—the corporate level—at the highest rate ongoing is in an incentive to add debt.

Mr. ARCHER. I said that was going to be my last question, but I asked one before to a panel, and I never got a concrete answer. Maybe you two gentlemen can give me one.

If, in fact, the deductibility of interest and the nondeductibility of dividends is the reason why we have had the advent of these LBO's, and if the corporate tax rate is also involved, then why did we not have a greater intensity of them when the corporate tax rate was 46 percent?

Mr. TREIGER. I would like to ask Mr. Wellen to address that question.

Mr. WELLEN. Mr. Archer, my name is Robert Wellen of Washington, DC. I am a cochair of the American Bar Association tax section task force on LBO's.

My response to that is, first of all, we now have for the first time, as you pointed out, sir, an inversion of the rates. That is, the corporate rate is now higher than the individual rates.

Therefore, even assuming that all investors are fully taxable at the highest marginal rate, you can still reduce the overall tax burden by paying out income as interest versus retaining it in the corporation. So that the investors pay tax at the highest individual marginal rate of 28 percent as opposed to the corporation's deduction at the corporate rate of 34 percent. So, I think even though corporate rates are lower, several of us in the task force have observed at our meetings with our clients that the inversion itself has had an impact on these transactions.

But I do not want to overstate that, either. In fact, out of the 28 or so people on the task force, there was not one who felt that these transactions were, in fact, tax driven. The feeling is that taxes are part of the background. There certainly is an incentive to go forward with them, but the other conditions in the securities market, such as the rise of junk bonds and other financing devices, have probably had more impact in recent years than the tax law changes.

Mr. ARCHER. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Pease.

Mr. PEASE. No questions.

Chairman ROSTENKOWSKI. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. Treiger, I did not find it unusual that you mentioned as an option the disallowance of interest deduction. I think it is perfectly within the range of policy options for Congress to consider, that is, allow an interest deduction or limit an interest deduction on certain kinds of debt instruments.

I might add that I also agree with the last gentlemen this spate of takeovers, whether LBO's or mergers, is not tax driven. I really do not believe it is tax driven. There may be some incentives but I think it is driven more by the availability of junk bonds and presence of moneymakers who peruse the stock market to find undervalued assets and use junk bonds to purchase them, break them up, and make some money.

That is what I think drives this. That is what I think is the engine that drives all of this, and that is why I think we should look at junk bond policy considerations. Are junk bonds equity masquerading as debt? Are they instruments that we should be evaluating for the purpose of interest deduction treatment here on the committee?

Mr. Treiger, I do not think the suggestion is out of line at all. It is something that we ought to seriously consider, and I appreciate it being in the report.

Mr. **Treiger**. Thank you, Mr. Dorgan. Again, we are suggesting that only as an alternative and only to pay the cost of partial integration if Congress should go in that direction.

Mr. **Dorgan**. Yes, I understand that. My sense is that there is no one on the committee who will seize on this in a manner that is unfair to the bar association, but again, my sense is that we want to be very careful in what we do. We should not indiscriminately say, "Debt is bad and therefore, let us try and provide a substantial disincentive for debt through the Tax Code."

All of us who are working on this understand the need to be very careful and very judicious in what we might or might not do with tax policy.

Let me ask one final question. The other observation I have about all of this takeover activity is that it is driven also by a spectacular failure of regulatory agencies.

You probably have to go beyond one hand to mention all of the agencies that apparently are riveted to their seats doing nothing while all of this is going on. Would you comment on that? Does anybody agree with that observation?

Mr. **Treiger**. This question is beyond the area of our purported expertise, and——

Mr. **Dorgan**. Do not be modest. [Laughter.]

Mr. **Treiger**. I think that there probably have been some lapses, and of course it is our position that we should be looking in those directions rather than at the Tax Code, if there are problems with LBO's here—securities laws, enforcement of fiduciary obligations, and the like.

Mr. **Dorgan**. Thank you, Mr. Chairman.

Mr. **Hoffman**. Mr. Dorgan.

Mr. **Dorgan**. Yes.

Mr. **Hoffman**. I agree with the observation. We have suggested that if there is a problem—and I think that we have stressed that it is for Congress to decide whether there is that problem—if there is a problem, the direction should be in the securities law area, the regulatory area. If, indeed, they have been sitting on their hands during this period of time, then the objective should be to identify the problem and decide what regulatory agency should be prodded to pursue it.

Mr. **Dorgan**. I thank the panel very much for some interesting testimony.

Mr. **Gibbons** [presiding]. Mr. McGrath.

Mr. **McGrath**. No questions.

Mr. **Gibbons**. Mr. Downey.

Mr. **Downey**. Thank you, Mr. Chairman. I think that the testimony of the bar—the lawyers—has been most interesting. We have managed to find just about anything we want from your testimony, and let me congratulate you for that bit of legerdemain.

Mr. Archer and I will find your first recommendation the most convincing, and that is that we should do nothing. Mr. Dorgan will find others where you have, indeed, suggested that we do something. So, once again, the lawyers have managed to be on both sides of this question, and for that, you need to be commended, Mr. Treiger.

Let me ask you a different question. To what extent have we already, in your experience—Mr. Hoffman and others on the panel please comment on this—have you already begun to see the tightening of credit rules and investment criteria on LBO's by banks and others? Has any of that happened? Have there been any attempts at self-regulation that any of you have discerned?

Mr. HOFFMAN. I can only speak in general terms. My sense is that there is an overriding caution that is developing. I think that the concerns about the debt burdens in LBO's have been publicized, and the investor in LBO debt has to be cautious and probably is becoming cautious.

I would say that it is, in a sense, self-regulating. The investor will, I believe, back off in the face of the negative publicity that has taken place concerning LBO's.

Mr. DOWNEY. To what extent do you see the efforts of Federal Reserve Bank examiners pressing the highly leveraged companies or banks in their loan portfolios? I believe we have had some testimony here that this is something that the Fed is going to examine more closely and pay more attention to.

Mr. TREIGER. I personally have not observed it, but that does not mean it does not exist. I have been reading—I read the press just as we all do, I guess—that apparently someone is trying to look at these issues.

Mr. DOWNEY. OK. Thank you, Mr. Chairman.

Mr. GIBBONS. Mr. Sundquist.

Mr. SUNDQUIST. Pass.

Mr. GIBBONS. Mr. Moody.

Mr. MOODY. Thank you, Mr. Chairman. Do either of you think that LBO's are bad?

On page 11, Mr. Hoffman, your testimony says, "the perceived abuses in the economic environment." Is the emphasis on the word "perceived," or "abuses"?

Do any of you believe that LBO's should be curtailed? Not through tax laws as you apparently say, but in some other way? Are they something we should curtail? Are LBO's bad or good?

Mr. Hoffman. Mr. Treiger.

Mr. HOFFMAN. We all have read the testimony of those who have come before us—their conclusions, economists conclusions, and those who engage in the LBO activity.

What we also see are statistics in the report of the staff of the joint committee that corporate debt is rising, and corporate equity is declining, speaking very generally.

I can only express personal attitudes, because I am not speaking for any organization at this time. I personally am concerned when corporate debt rises and corporate equity declines. I am concerned that, at a time in the future when there is a recession, it would catch up with some companies.

But I cannot make that judgment. I think it is for the Congress to decide whether or not there is a long-range economic problem in the developmental stage as a result of LBO's.

If Congress decides that is the case, they can go several ways. One would be regulatory agencies, and so forth. The other choice would be the tax law, and that is what we are saying should not be used——

Mr. MOODY. You are not stating whether or not there is a problem, but if there is, if Congress acts to solve a perceived problem, it should not be through the Tax Code. Correct?

Mr. HOFFMAN. That is correct.

Mr. MOODY. Mr. Treiger, do you agree with that analysis?

Mr. TREIGER. I concur with that.

Mr. MOODY. OK. Mr. Hoffman, you say verbally, and your testimony more or less says in other ways, that you would not change anything in the tax law. And one of the arguments you use is that a change would provide benefits to foreign buyers because they could figure out multiple ways of picking the most hospitable tax climate available to them. Therefore, the U.S. domestic bidders and owners would be competitively disadvantaged. Is that accurate?

Mr. HOFFMAN. That is correct, Mr. Moody.

Mr. MOODY. But I want to get back to your statement that you would not do anything. Are you aware that current tax law provides substantial benefits to foreign purchasers right now? You would not even move to remove that?

I draw your attention to the testimony which will be coming up shortly after you from Mitch Fromstein. His testimony shows that a British company bought out his company and enjoyed an enormous tax advantage that is not available to U.S. companies under current U.S. law, in terms of goodwill. Under British tax law you can immediately expense goodwill.

His company was bought for $1.3 billion, over a billion of which was goodwill. Service companies, unlike industrial companies, have very little fixed assets, very little book value in terms of tangible assets. Most of it is goodwill—reputation, service, employee contacts, and so forth.

The current tax law does substantially disadvantage U.S. firms already, and yet you said that you would change nothing. Could you comment on that. Do you still feel we should not change anything?

Mr. HOFFMAN. Well, I am not clear about the deal, but if I understand it correctly, and Mr. Treiger can tell me if I am wrong, if you buy goodwill in the United States, you do not write it off.

So, it is not the U.S. Tax Code that would be favoring this particular investor, because if they paid $1.3 billion that $1 billion would not be available as a writeoff under U.S. tax law. So if it happens that the foreign investor has created his investment vehicle through a foreign country which allows a writeoff, that would be very different.

Mr. MOODY. Well, my point is that you say the problem is not U.S. Tax Code—it is British Tax Code. But that is the tax code of many European countries, and when they unify into one economic market, this effect will only compound.

So the question is, Should we change U.S. Tax Code in order to take account of the Tax Code that exists out there in European countries, including England in this case?

Mr. HOFFMAN. That envelops the entire principle of the treaties, and I do not know how it would impact. I would be happy to have our organization study it and come back with a report to you.

Mr. Moody. Thank you. We will give you a copy of the Mitch Fromstein testimony, and maybe you can reply later.

Mr. Hoffman. All right.

Mr. Moody. Mr. Treiger, do you have any comments?

Mr. Treiger. No, I think that the issues you raise here go far beyond the issues we are addressing today.

There are disparities between foreign governments' treatment of these items and U.S. treatment, but I do not think we are going to solve those by dealing with the issues that we are discussing today. They may require a far broader review of the tax laws.

Mr. Moody. My only point is that you are rightfully concerned about differential international impacts of changing our tax law. You point out that doing some things that are mentioned in the eight options would almost invariably favor foreign operators.

Mr. Treiger. Yes.

Mr. Moody. I want to bring your attention that current tax law favors foreign operators as they acquire U.S. companies. Therefore, we might want to revisit your position of "doing nothing" to the extent——

Mr. Hoffman. Mr. Moody, clearly the foreign tax laws are what we were speaking of when we are talking about the favorable position of foreign companies. Any change of the interest deduction in the United States that would impact negatively a U.S. competitive bidder for a U.S. company is going to further exacerbate the problem.

Mr. Moody. Not interest. I am talking about goodwill, but we will——

Mr. Hoffman. Yes.

Mr. Moody. Thank you for your written response, if you would be so kind to provide it?

Mr. Hoffman. Yes, sir.

Mr. Moody. Thank you.

Mr. Gibbons. Mr. Chandler.

Mr. Chandler. No questions.

Mr. Gibbons. Mr. Coyne.

Mr. Coyne. No questions.

Mr. Gibbons. Mr. Pickle.

Mr. Pickle. Gentlemen, we have received a lot of views and cautions from you, but little suggestions of what we might do. One of you said that we ought not act in panic. The Congress is not acting in panic on this question.

It has been brewing now for 4 or 5 years. Three years ago, we tried to look into the question of limiting junk bonds, and we could not figure out a good way to go about it, because it is a complex question.

I find most of you think we ought to be very cautious before we proceed. Now we know that, so I hear you, but I am trying to find some kind of an answer, and I do not find much in the way of suggestions.

Of the eight proposals the Joint Tax Committee made, Mr. Hoffman noted his interest in the suggestion that a corporaton could be required to recognize gain on its appreciated assets when it borrows against those assets and distributes the proceeds to its shareholders.

But I think the first question we ought to ask ourselves, is why have these leveraged buyouts expanded so largely in the last 4 or 5 years? Why has it become now the new national game by corporate America?

In my judgment, raiders of corporations try to make money now through the deals themselves more than in having a factory business and building up its productivity. I personally think part of the problem is in the junk bond area, and that is why these deals have become so big.

You point out to me that it is because we have changed the law on the *General Utilities* doctrine and a few other changes, but maybe it is the closing of the gap between individual and corporate rates.

But I do not think we really have answered why it is, but the leveraged buyout is a new game in town, so to speak—the new national game. How you can make a profit other than to do it through productivity.

We are trying to find out what is the answer to this thing. Now, Mr. Hoffman and Mr. Treiger both have said that there could be a more thorough aligning of the tax treatment of dividends and interest. You throw that out as an alternative.

I think Mr. Treiger said it would be desirable if we had a better alignment. So, the question I ask you is, is it possible to have a proper balance between interest and dividends that would be fair and balanced?

Is there such a balance that can be reached? A number that could be maintained? Do any of you think it could be?

You throw that out as a possibility, but it is just kind of as a second thought, or an afterthought, not a recommendation.

And I'm trying to say, is it possible to have a proper balance between an interest deduction and a deduction for dividend payments?

Mr. **Treiger**. Mr. Pickle, indeed, we think it is, and I would like to ask Mr. Wellen to address that question.

Mr. **Wellen**. Mr. Pickle, we gave a lot of consideration to that very question in our task force, and our report which we will be submitting to you next week will have much more material on that than we are able to give you this morning.

I would just like to make a couple of points. We do think it is possible to balance, or at least to improve the balance between the treatment of interest and dividends. Whether it is possible given revenue constraints to achieve a complete balance in the short term, I really don't know. I am skeptical, frankly, that that's possible.

But we do think that it is possible to close that gap to some extent.

For example, one approach would be to provide a partial deduction for dividends paid as was provided for in the House-passed version of the bill which became the 1987 act. We think such a step would be constructive in that respect.

When we focus on these questions of improving the balance between interest and dividends, it occurred to us that there were really four different areas that ought to be considered.

To begin with, in the corporate area we want to improve the balance between the treatment of debt and equity. Then, when we look at corporate business versus noncorporate business, we want to improve the balance between the taxation of corporate business, on the one hand, and of noncorporate business on the other.

So, we have corporate debt, corporate equity, noncorporate debt, and noncorporate equity; and we think to move in one area without considering all four would be a problem.

Mr. PICKLE. Now, Mr. O'Connell, and I don't know whether you were responding to Mr. Treiger's suggestion, and I don't know whether Mr. Hoffman agreed.

Mr. O'CONNELL. Yes, sir.

Mr. PICKLE. I'm not asking that you present to us the perfect amount, but we need to know is it possible, and what is the approximate level?

Now, you've known this problem has been in existence for years and years, and I don't know how much it helps us to come and listen to you tell us about all the caution and the care we ought to exercise, but what do we do about it?

I think the Joint Tax Committee is studying the question.

And that's what I'm looking for, and I don't think that anybody has really suggested anything except that it's an alternative, or it's kind of an afterthought. And it seems to me like that is something we ought to pursue more specifically.

Now, I'm rather opinionated, and I admit it. It just seems to me that a lot of this is being brought about because of the use of junk bonds. It's the new national game, how you can make big money.

When you see an RJR-Nabisco deal, where a raider takes over in a $24 billion transaction, I don't think that's healthy for this country, and I think business as a whole is wondering what in the world is going on. It's nice to view with alarm, but I think we are being asked, what can we do about it?

And that's what I want to continue to look at: What can you do? I am perfectly willing to give you some relief in the dividend area. I think it has got to be balanced off in the interest deduction area. But that's a personal opinion of mine, and I admit it.

Mr. HOFFMAN. Mr. Pickle, you're asking for a balance between dividends and interest, and presumably there can be the perfect balance, the arithmetic balance, to equate the two.

But that would be over the system as a whole, not necessarily as to the particular enterprise so that the small corporation that doesn't pay dividends because they are trying to reinvest in the plant and equipment is not going to be internally balanced by the disallowance of part of their interest.

We would be very concerned about a general disallowance of interest in order to generate the revenues.

Mr. PICKLE. I think you make a point. I recognize that's a problem.

But I'm inclined to say to you, I'm tired of hearing all the problems, and I'm going to say, what do we do? And I think that's what this committee is being asked, is to come forth with some kind of recommendation, if there is one. I think there should be one.

Mr. GIBBONS. Mr. Stark.

Mr. STARK. Thank you, Mr. Chairman.

I'm sorry that I was unable to hear the panel's testimony, but in listening to my colleagues inquire, I think that I get a sense of your concerns.

I am not sure that this committee is charged with, or would know how, as you have heard, to make a decision as to what we, what normative decisions we ought to make relative to leveraged buyouts.

One person's bad one is the other person's good one, I suppose. But we are charged with raising revenues, and let us just assume for a minute that you joined the business council, and many others, to say that the Tax Reform Act of 1986 put us where we ought to be, corporate taxes at somewhat, pretty close to 10 percent of the total revenues we collect in this country, back to about the historic area, and last year a little under a $100 billion, estimated, let's say, at $103 billion this year.

No real complaints about the aggregate amount relative to what payroll taxes are providing in over $400 billion, and what individuals are providing at about $450 billion.

But our committee's job would be this, and it would be a very simple thing and we wouldn't have to get into this discussion with you.

Let's assume for a minute that we are anticipating $100 billion, as I can do the math with my shoes and socks on, and that next year we only collect $90 billion. And we can identify fairly quickly that the $90 billion was due to the base erosion of increased interest deductions, and that would stand out for us on aggregate figures. It would be clean. Everybody would understand it.

We'd say, "Wait a minute, with profits being equal and everything else being equal, we lost $10 billion because interest deductions went way up." My reaction would be to say, "That's easy. We just go then and kick the corporate rate to 38 percent, and we're even."

Would that seem like—let the corporations decide how they are going to divvy up their deductions, what they are going to do, and we'll just keep them right about a constant share; and if it works, that they get a lot more interest deductions, we'll raise the corporate rate.

Is there anybody who thinks that's unfair?

Or unwise?

Mr. Treiger. Are you suggesting, Congressman Stark, that this would be with the individual rates staying where they are, so that you would exacerbate——

Mr. Stark. Yes. Yes.

Mr. Treiger. You would exacerbate the inversion that now exists?

Mr. Stark. I mean, we've got, at some point, something has to be paramount in our decision. Is that the balance between corporations and individuals? I suspect that the individuals are paying—if you lump together their payroll tax, they outdistance the corporations by a country mile.

The pressure right now is aggregate revenues, actually. I suspect that the deficit is of greater concern politically and economically in the country than, say, the R&D tax credit, or any little piece of the corporate code.

So, if that's a question, and whatever might drive it, I'm just suggesting here that the interest, the change from equity to interest might do it. It could be a whole increase in advertising. I'm not suggesting for a minute that they—but it seems likely, and one of the fears that the tax people tell us is that this huge buildup in debt could really erode the corporate base and create that kind of change.

And I'm saying if we could see that it was interest that did it, instead of trying to limit the deductibility of interest or a whole host of other things, why not just—the simple fix is to raise the corporate rate.

And would any of you object to that as opposed to fussing with a variety of plans for limiting interest deductions?

Mr. HOFFMAN. Well, Mr. Stark, the decline of the corporate revenues might be attributable to increased debt, but it may be as innocent as the fact that the cost of debt is rising.

Mr. STARK. We've got to be—that would show up. I mean, those aggregate figures are so plain and so easy that even a person as uneducated in economics as myself could spot it.

In other words, if the prime rate went from 6 to 9, and that was the increase in the interest paid by corporations, that—well, let's assume for a minute that interest rates stayed fairly level, and you could attribute just a major increase in debt financing for corporations, and that led to a decrease in revenue. Not a hard trail to find.

Mr. TREIGER. It is conceivable to me that the further increase in the corporate rate could just accelerate that trend, in other words, just push more corporations to debt and not give you——

Mr. STARK. I guess in our simplemindedness here, we would just follow that trail on and on and on.

But I have no qualm. I'm not trying to punish. It would seem to me that's not punishing leveraged buyouts; that's just getting our share out of the corporations.

Mr. HOFFMAN. Well, you're suggesting that you avoid dealing with the interest deduction as such, in that scenario. Then you accept the fact that it is difficult to analyze which is good interest and which is bad interest?

Mr. STARK. It certainly seems that way here.

Mr. HOFFMAN. There is a lot of the interest in the United States that is "good interest" to keep the business——

Mr. STARK. No, I have no qualm. I'm not trying to make any judgment. I'm just saying—and this same thing, I mean, we could react the same way to superincrease in advertising or something else.

I'm just suggesting that because the topic here is if we could say that for some reason it could seem not very productive to us.

Mr. HOFFMAN. Well, as an organization, and I'm speaking for an organization, we have talked about the desirability of limiting changes of the tax law.

Mr. STARK. I agree.

Mr. HOFFMAN. So, if you go to interest and to advertising, and to other deductions, and say, we are going to disallow 20 percent of them, or 80 percent of them, or whatever, you are changing the tax law in ways that are very complicated, and affect a broad base of targets.

If you change the rates, obviously you are not creating the same complexity. You're adding a point or two, and it's easy to calculate. There are other fall-outs, as Mr. Treiger has said.

As you increase the rate, you get an increase of debt, because the deduction becomes more interesting.

Mr. STARK. I understand all that, but we can't get any unanimity out of the panel on what we ought to do if the interest goes up, so I'm saying, let's back away from that. Why should we clutter our minds, and worry our souls?

Because really all we're interested in here is collecting our fair share of revenue.

Mr. MCGRATH. Would the gentleman yield on that point?

Mr. STARK. Go ahead, sure.

Mr. MCGRATH. Conversely, should the receipts from corporate tax exceed the 10 percent, would the gentleman be likely to recommend that the rebate be given to corporate America?

Mr. STARK. Well, if you could make a case that 15 percent is strangling productivity, and hurting the country for some reason, and it wasn't just superincreased profits, as a result of all the incentives we are giving, now I'd have no quarrel if there were some reason, say, we are collecting too much in tax, although in this budgetary climate, I don't really see that as a likely option until we begin to balance out the budget.

Mr. MCGRATH. Well, it seems to me that the entire thesis being——

Mr. STARK. To answer your question, I like the idea but just in rates, whether it's on individuals or corporations——

Mr. MCGRATH. On an annual basis?

Mr. STARK [continuing]. As long as we have the base as broad as possible.

Mr. MCGRATH. I think on an annual basis, it would be tough to do.

But, on the other hand, I think the thesis ignores the fact that perhaps because of the disparity between the corporate rate being higher than the individual rate, that some income is being taken on the individual side, and that perhaps revenues would be increased on the individual side as they must, because your thesis assumes that revenues remain constant; and they haven't. They have always increased.

Mr. STARK. The only thing I'm asking is that the panel has some reservations about tinkering with deductions and limits in the Code, and the easiest and broadest adjustment is the rate, and I'm just suggesting that if we find a problem that ends up in revenues, I'm told that the bigger the spread, actually, historically, of personal and corporate rates, the more the incentive for corporations to go into debt.

Don't ask me to understand that, but that's what my staff tells me.

Mr. MCGRATH. Would the gentleman yield further?

I worry a little about the intrusion into the interest deduction, because, as it has been articulated by those on the panel, where does it end?

Mr. **Stark**. That's what I'm saying.

Mr. **McGrath**. We could begin to get into areas that we had no intention of getting into; we could start reducing the value of interest deductions for things that have absolutely nothing to do with the problem that brings us here today, and it seems to me it's a harbinger of bad things to come.

Mr. **Dorgan**. Would the gentleman yield?

Mr. **Stark**. I would be glad to yield to the gentleman.

Mr. **Dorgan**. I think it's worth noting that the panel also indicated they don't believe that this wave of takeovers is tax-driven I'm not as reluctant to deal with the question of deductibility. My own view is that this wave of takeovers is largely driven by the advent of junk bonds and the ability to market them, and provide liquidity for them.

It is not unusual then for us to evaluate what junk bonds are: Are they equity or should we deal with the question of deductibility of junk bonds?

I think that is something that we should consider.

Mr. **McGrath**. Well, if the gentleman would yield, on that particular subject, I don't have as much of a reticence upon the issuance of junk bonds as perhaps Chairman Pickle does, because we've had hearings on this specific subject over the years, and our committee has not been able to even define what a junk bond might be.

If we are going to limit junk bonds in its most basic definition to any bond that is not a AAA bond, I would suggest that there are very few companies out there that have that kind of a rating, and if we are going to start limiting our ability to finance either hostile or friendly takeovers by just those bonds that may be AAA bonds, I suggest that we wouldn't have a heck of a lot of capital around.

Mr. **Stark**. Thank you, Mr. Chairman.

Mr. **Gibbons**. Junk bonds are bonds of issue of which I do not approve. [Laughter.]

Mrs. Johnson.

Mrs. **Johnson**. Thank you, Mr. Chairman.

I'm sorry I haven't heard all the testimony of the panel, but I have heard some of it, and reviewed some of it, and I just want to put my concerns in the record and see if you have any comment.

I appreciate your interest in government not doing too much and your preference for us not doing anything. But this debate that we are getting in about LBO's reminds me a lot of the notification debate, whether employers had an obligation to notify their employees in the incidence of plant closings, which, in a sense, pitted businesses' freedom and requirement to be able to make a business decision against people's need to be able to manage their lives.

And, after a number of years, we came to what I think was a very reasonable compromise because it gave business an either/or choice.

Now, there are enormous numbers of lives being affected by these deals. And some of them make a lot of sense. Some of them work very, very well. Some of them in my mind are correcting some of the excesses of the era in which big companies of America bought lots of little companies under the name of diversification and that was supposed to strengthen them; they didn't know anything about running those businesses, and the businesses didn't fare very well.

And in many instances, I am delighted to see these little businesses themselves back into where either they have more power, or somebody who knows their business has more power; and I see a lot of them turn around.

But by the same token, I see some very disruptive things going on. We have one going on right now in my district, where people with no business experience, particularly in manufacturing are going to buy out a big company saying we are going to sell off everything else and the manufacturer can do well on its own.

Well, didn't they read the studies that showed this company that they couldn't make it without bringing some more sophisticated, high-technology components to this manufacturing entity?

And one gets the feeling that there is a group of transactions going on that are being pursued for the wrong reasons and there ought to be some definitions that we could make, that we hold large transactions to.

There ought to be some burden of proof on the purchaser outside of "I've got the money to do this," that this is a reasonable deal and this is going to have some benefits for American business, American industry, for our industrial base.

I think what we're saying in holding these hearings, as many as we have held, is that we realize that a lot of this stuff is good activity, but there clearly are some deals that have been very destructive of people's lives, have destroyed good and able companies that were just getting into a high-technology level, that if manufacturing can't connect into, won't be here.

And it's very distressing. We keep hearing from the professionals that, while they acknowledge that there is some good stuff and bad stuff, you don't want to be a part of trying to decide how do we draw some, how do we set some criteria so that maybe we can anticipate what the bad stuff is going to be and find a way to make it more difficult for it to happen?

Do you have any things that you think we ought to look at? Do you want to do this in a regulatory way? What should the regulators be looking at? What are the higher levels of criteria? How is it that we can begin to differentiate between those deals that are fundamentally healthy and those that aren't?

Mr. HAWKINS. Could I——

Mr. GIBBONS. You have the time.

Mr. HAWKINS. Mr. Moody asked earlier whether LBO's are good or bad, and you pointed out that there are some which seem extremely good and that there is no flat answer to Mr. Moody's question.

I think another thing that is striking about your statement is that there is relatively little disagreement as to the particular cases that you mentioned. In other words, if you listed a series of things that happened in connection with an LBO, I don't think there would be much dissent as to which of the things are good and which are bad. Everybody likes efficiency, and everybody doesn't like the disruption. Still another striking thing, however, is that these are all nontax factors.

All the things that you mention are important, and all of them are factors we would use to evaluate an LBO in our own minds, but none of them are really tax considerations.

The first conclusion in our report is that if you have nontax reasons to do something or to block something, the use of the Internal Revenue Code to achieve that result is unwise. In other words, if we found that there was a certain kind of LBO that was very bad for nontax reasons because of its effect on the community, the implied suggestion is that, as tax people, we ought to craft a tax medicine that would stop just those LBO's and no other LBO's. Our concern is that we don't think that we are that competent or that the Tax Code is that suitable a mechanism. Some past efforts to use the code to solve perfectly genuine problems but nontax problems have not been very effective and have had tremendous costs.

It is not a cost-free experiment since every time you change the code and make it more complicated, then you have problems of compliance, you have problems of taxpayer morale, enforcement, and so forth.

Mrs. JOHNSON. Well, I understand that, but at this same time, everyone seems to agree that the way our Tax Code is structured is one of the causes for this activity: Our treatment of interest versus equity. That has an influence on this——

Mr. HAWKINS. It is rain which falls on the just and the unjust alike. In other words, the interest is just as deductible whether it is one of these bad LBO's or one of the good ones, so that our concern is that it does not distinguish very well.

Mrs. JOHNSON. That's my concern, too, but I think that we can't just say we don't have any criteria. I think we have to begin to find the criteria.

Any other comment?

[No response.]

Mrs. JOHNSON. Thank you, Mr. Chairman.

Mr. GIBBONS. Thank the panel very much for their testimony. That's helped a lot. Let's go to our witnesses now of Mr. Lee, Mr. Manor, and Mr. Fromstein.

Since Mr. Moody is here, Mr. Fromstein is here, let's kind of reverse the order, and I would like for Mr. Moody to introduce his constituent, Mr. Fromstein.

Mr. MOODY. Thank you very much, Mr. Chairman.

Mr. Fromstein owned a company called Manpower. In the past 18 months it has been a takeover target, and he's been an active seeker of LBO financing to recapture this target.

Therefore, he comes to this committee with a great deal of hands-on experience. I think the interesting element of his testimony is what the effects of current U.S. accounting and tax laws are in the sense that they favor foreign takeovers and make it more difficult for U.S. industry to reacquire firms.

So, I look forward to his testimony.

Thank you.

Mr. GIBBONS. Then, why don't we start with you, Mr. Fromstein?

Mr. FROMSTEIN. Thank you.

Mr. GIBBONS. Then we'll go to Mr. Lee and then Mr. Manor.

STATEMENT OF MITCHELL S. FROMSTEIN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MANPOWER INC., MILWAUKEE, WI

Mr. FROMSTEIN. I want to thank the chairman, and the committee, and the staff for extending an invitation to me to speak to you this morning.

While I am not an authority or an expert on these subjects by background or by practice, I have in the past 18 months, as Congressman Moody mentioned, been a takeover target, an active seeker of LBO financing, and a recapturer in the end of the original target company—all of which qualifies me, at least, to be an educated observer on some of these practices.

In the interest of time, I am going to address some very specific aspects of the issues which may not come to light in a broad investigation, but they do, I believe, have a very pragmatic impact on our economic society.

My first point relates to the LBO as a very practical option to companies facing hostile takeover attempts, particularly those involving foreign corporations as the corporate raider.

Because of a vast differential in the accounting treatment of purchased goodwill between the United States and other countries, particularly Britain, a U.S. firm has virtually no opportunity to seek competitive bids from other United States companies.

A British firm can, for example, offer a 20- to 50-percent higher premium for shares of a target company than a United States company can because they can write off the goodwill in one almost unnoticed event while American companies are required to charge after-tax earnings with a goodwill cost for over a period as long as 40 years.

With no logical U.S. buyers at hand, therefore, a company finds it very difficult to defend itself against a foreign takeover, except to attempt a leveraged buyout to meet or exceed the foreign offer.

To make an LBO impossible by declaring interest nondeductible would, in fact, remove the last resort for a foreign takeover target to remain as an American company.

Because a privately held company doesn't care about the required goodwill charge-off, the LBO becomes an important defense against losing American-based companies to overseas interests, and particularly service companies.

I would urge you to consider this positive aspect with care when measuring the pros and cons of a leveraged buyout. If this option is destroyed, you must create a replacement or an exception, or risk the continual loss of U.S. companies, particularly service companies, to the foreign market.

In my own case, as chief executive of Manpower Inc., in September 1987, a British company was able to pay a multiple of our per-share earnings, which was double that which any U.S. company could afford to pay.

Thus, you lost a service industry giant to foreign shores. Unfortunately, we didn't have the time to arrange a leveraged buyout in the short defense period that was allowed.

This brings me to my second and perhaps more important point related to corporate takeovers.

When a U.S. company is lost to foreign interests, there is virtually no way it can ever return to the American economy again as a public company. It is, in fact, exiled to foreign ownership, even in a case where the foreign merger, or takeover, did not meet with success.

The reason is that an existing SEC regulation called the "Push Down Rule" requires that goodwill associated with a purchase or a merger remains on the books of the company for which the goodwill was paid.

If and when that company is sold, or spun off, or merged, or disposed of by the foreign owner, it carries the goodwill back along with it, into the new or changed status.

In our specific case, my company, Manpower Inc., was purchased by Blue Arrow, PLC, a British company, in 1987, for $1.3 billion. Of this purchase price, over $1 billion of it was classified as goodwill.

In Britain, on the books of the acquiring company, all of that has been written off with no impact to company earnings whatsoever.

If Manpower Inc. were to return as a U.S. company, which is a distinct possibility, it would be necessary to carry with it, for U.S. accounting and SEC reporting purposes, all of that amount, and write it off annually, with no tax advantage for 40 years. Essentially, that would make it impossible to move back as a U.S. public company.

On the other hand, another British company could buy it without any goodwill impact on earnings, as it could write off that goodwill immediately.

The existing Financing Accounting Standards Board rules and the SEC "Push Down" regulations related to the treatment of goodwill have not, in my opinion, faced the economic facts of life in the United States.

Three of them are quite important: One is that service companies are growing in popularity and have outpaced even manufacturing industries in the rate of growth so there are more service companies in the United States.

No. 2, the United States has grown the best and the brightest and the largest service companies in the world.

No. 3, service companies typically have the largest portion of their assets in goodwill. The value of that goodwill lies in what someone will pay for customer relationships and operating people rather than fixed assets.

In today's global society, it is not unusual to see a change of circumstances which results in the divestiture of all or part of the target company. This could take the form of resale, as I said before, a spinoff, a management buyout—all of which could involve ultimate access to capital markets in the United States.

Call it, if you will, "the unwinding of a deal," which, in many instances, is the opportunity to recapture a former U.S. target company.

The goodwill element, after all, is revenue-neutral. It has no cashflow impact. It has been rendered as a sterile element by the arbitrary differences in the accounting treatment, country to country.

In my opinion, if we fail to recognize a need for flexibility , I fear that the European Economic Community emergence in 1992 will compound the problem and threaten to deprive this Nation of the service-company infrastructure that we need to remain competitive in the global marketplace.

It is bad enough to ask our service industries to defend against foreign takeovers on an uneven accounting playing field, but present regulations virtually slam the door in their face when they somehow acquire the ability to return.

The SEC should be, in my opinion, urged to selectively waive the "Push Down Rule" in these circumstances, and/or companies returning to a U.S. domicile after a hostile takeover should be allowed to treat goodwill in the same manner as the acquirer was allowed to treat it under its own country's rules.

Thank you.

Mr. GIBBONS. Thank you, Mr. Fromstein.

Are you the Manpower we find all over the United States?

Mr. FROMSTEIN. Yes, sir.

We operate in 33 countries, and we are probably one of the major exporters of services, American-based, and we have 750 offices in the United States alone.

Mr. GIBBONS. Well, that's interesting.

I'm not going to question you now, but you used to help me do my Christmas cards, and——

Mr. FROMSTEIN. Well, thank you for the business.

Mr. GIBBONS. It shows you how perverted Christmas can get—Christmas cards, anyway. [Laughter.]

OK, let's see, let's go next to Mr. Lee.

STATEMENT OF THOMAS H. LEE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THOMAS H. LEE CO., BOSTON, MA

Mr. LEE. Yes, sir, Mr. Chairman, and distinguished members.

Thank you for allowing me to appear before you today.

I am not going to give a speech, but I am going to really talk off the cuff about the leveraged buyout business.

Mr. GIBBONS. Sure, go right ahead.

Mr. LEE. I've been in the business now for 15 years. I started a firm bearing my name in Boston, MA, in 1974, after I left the Bank of Boston, where I was a young VP lending to high-growth companies.

Over the years, I have purchased over 75 different firms, using the leveraged buyout method, which you have all heard so much about.

Mr. GIBBONS. Do you still own them all?

Mr. LEE. We own by far the bulk of the firms, which we have bought in terms of size and scope. I would say that when we go into a transaction, we are typically looking at a 5- to 10-year time horizon, although there are some companies with me yet today that I bought, say, 12 years ago.

We invest our own capital and that of a public limited partnership, which we raised through Merrill Lynch, in 1987, which has approximately $700 million of capital supplied by 40,000 limited partners.

The hallmark of our firm has been friendly leveraged transactions. We have never been engaged in a raid, we have never been engaged in a hostile deal of any sort whatsoever.

The other hallmark has been growth companies, and contrary to the popular opinion in the press, we have found that the best way to handle a buyout is to grow the company after the acquisition.

We were asked by Ken Lehn, who is the chief economist of the SEC, to prepare a study of the going private transactions which we have been involved in. You will find the results of this study in tabs 2 and 3 of my testimony.

We studied the capital expenditure rate, the employment rate of the companies which we bought in a period of 1980 to 1987, and you will find that we increased employment from 45,000 to 59,000 people in the companies which we studied nationwide; and the annual capital expenditure level went from $70 million to $130 million in these companies.

I would say that today the companies which we have a major stake in have sales of about $8 billion and employ some 70 to 75,000 people in virtually all States.

We believe that leveraged buyouts are the underpinning to the stock market today. There is a very large private capital market that exists that, in response to one of the questions earlier, isn't a regulated market.

You know the size of the New York Stock Exchange. I think the market values are about $3 trillion. The size of the private capital market could be around one-third of that. That is to say all the values of the companies that have been taken private plus the other larger companies that have never either gone public or been sold.

We feel that the private capital market today is vibrant and buoyant and it is the underpinning to the stock market. We feel that it is necessary to keep the private capital markets in this country free.

Every company, almost without exception in this country, was started by an entrepreneur. Every company, whether it is U.S. Steel, or Exxon, or General Motors, was started by an individual who had thoughts that he would build up the company. He would probably hold it for most of his life, but that he might be able to sell it at the end.

And, as Mr. Fromstein has mentioned, if you eliminate buyouts, I believe that you will see foreign investors coming in here exclusively, or only large corporations which can buy other companies.

There was a recent study by Peat, Marwick, which showed $64 billion of foreign merger activity in this country last year by foreigners, whereas our companies purchased about $10 billion of companies in other countries.

So that I would beg you to understand that we are part of a large economy, a national economy, which really may be one reason—pardon me, we are part of an——

Mr. GIBBONS. International.

Mr. LEE [continuing]. International economy, which may be one reason why the recession that everyone thinks may be around the corner, and we thought it might be coming for the last 3 or 4 years, hasn't really come.

Anyway, we also returned these companies to a sharper focus. We bring in the managements; in some cases, as many of hundreds of managers own stock in these companies. In many cases, they own up to half the company.

We feel that competitiveness has really been sharpened, which is something that Chairman Greenspan spoke about just the other day, as managers and lots of managers become owners of these companies.

Again, I believe Mrs. Johnson spoke about the theory of the conglomerate, a few managers in a distant office could run, say, 40 disparate companies better than those managers. I think that theory has really gone by the boards.

So, really buyouts today, we feel, are a very sophisticated market. The banks are sophisticated. Chairman Greenspan certainly did a lot of jawboning after RJR. We don't find any kind of a feeding frenzy out there in the markets, and certainly the lenders are extremely cautious today.

We feel that you should study all the tax ramifications that surround buyouts, and certainly please do take a look at the capital gains which we have surrounding a buyout, because every time a company is bought it is certain that debt comes on the books, but most of that debt, most of the interest that the company now can't, doesn't have to pay a tax on, there is probably a tax paid by that bank, maybe at a somewhat lower rate. And most of the lending is done by the banks.

And we feel that the capital gains aspect should be studied carefully to see all of the tax is paid, so we would urge you strongly not to limit the free markets in this country.

Thank you very much.

[The statement of Mr. Lee follows:]

TESTIMONY OF THOMAS H. LEE

THOMAS H. LEE COMPANY
BOSTON, MASSACHUSETTS

Mr. Chairman and Distinguished Members of the Committee:

I am President and founder of the Thomas H. Lee Company, a private investment firm located in Boston, Massachusetts which has specialized in Leveraged Buyouts for the past fifteen years. Prior to founding the firm, I was a Vice President at the Bank of Boston and ran the research based lending department which made loans to fast growing, high technology firms. My senior partners include Thomas R. Shepherd, formerly President of two major Sylvania units at GTE, and John W. Childs, former Senior Managing Director in charge of the Capital Markets Group at Prudential Insurance.

We specialize in the acquisition of growing companies in the middle market. Last year we acquired major interests in some 14 companies and the purchase price of these transactions ranged from a low of $30 million to a high of $1.3 billion. Over 90% of the transactions we are involved in are private companies which is contrary to the general impression that most leveraged buyouts involve enormous public deals like RJR Nabisco. In a study just completed by Venture Economics, attached as an exhibit, the total number of buyouts publicly announced in 1988 was 304 of which 54% were under $100 million in purchase price which suggests private companies were involved; only 6% were over $1 billion.

The public/private distinction is an important one because LBO's provide the primary capital market to companies for which the public markets are inappropriate or, often, unavailable. LBO's have been an important mechanism for transferring family owned businesses. Frequently, this transfer is not to the next generation, but to the management which helped create the enterprise. The sale of a family business to another company instead of an LBO often means plant closings and loss of jobs in the name of reducing duplication for greater efficiency.

LBO's have also created an important market for the sale to management of the orphan subsidiary or division of larger corporations, those entities that are not part of the core business. These companies usually run better as freestanding, focused enterprises run by a manager/entrepreneur rather than a corporate bureaucracy. Again, the alternative to an LBO of the sale to another company would probably involve some painful downsizing in the name of efficiency.

Our investment process usually focuses on 100 companies which we are analyzing closely out of 1,000 opportunities we see annually. We try to understand the competitive nature of the firm, structure of the industry in which it operates and the strengths and weaknesses of its management. If and only if we determine that a leveraged buyout can be safely organized and financed, and that a company can withstand the effects of a possible future recession, will we proceed to enter a bid to be the sponsoring acquiror. Approximately half our time is spent in the analysis and study of investment opportunities and the other half is spent in working with the management of companies to assist them in their growth plans. While we have occasionally closed down an unprofitable plant or division, the overwhelming emphasis of our firm is placed on expanding companies after the buyout. We insist that the managements of the companies which we buy invest along with us, and it would not be atypical to find hundreds of management personnel owning up to half the equity of a buyout which we sponsor.

We were asked by Kenneth Lehn, Chief Economist of the SEC, to prepare a study of those companies which we have taken private. You will find this study in the appendix of this memorandum. We also studied all other companies acquired by us between 1980 and 1987 because only a few of our investments have involved public companies. Contrary to popular opinion, we have found that the vast majority of our companies have grown faster in terms of sales, capital expenditures and employment after the buyout than before. Specifically, of companies acquired between 1980 and 1987, employment rose from 45,000 employees at the time of acquisition, to 59,000 employees either currently or at the time an acquisition was divested. In the aggregate, annual capital expenditures have risen from approximately $70 million to approximately $130 million annually after the buyout. The total sales of these companies since the buyouts, have grown at a compound annual rate of 14.5% far surpassing the GNP growth of 6.5% for the comparable period. Notably, this analysis is not skewed by a concentration on one faster growing sector of the economy or geographic area and includes retailing, service, and manufacturing firms.

On the following pages we have provided abbreviated histories of two growth buyouts. They are illustrative of many more.

1) One of our largest acquisitions is Hills Department Stores, Inc. ("Hills"). Hills was formerly part of SCOA Industries, Inc. which operated department and shoe stores, leased domestic departments, a chain of off-price apparel and housewares stores, leased footwear departments, and an importer of footwear. Although SCOA's sales were growing at a compound annual growth rate of 11% for two years prior to LBO in December 1985, its operating income margins remained relatively low at 6% of sales. Hills, which was SCOA's core business segment, opened only 2 stores during 1985 although Hills' return on capital investment historically had been high. This was due, in part, to a lack of entrepreneurship and strategic focus by the company's corporate management. The management of Hills continually tried to present plans to grow the department store division and felt constrained by corporate management of the parent.

   Since the company was taken private through an LBO in December 1985, it has taken a number of new strategic paths to expand the company's business. In the first two years after the LBO, Hills opened 27 stores. In October 1988, Hills acquired 35 Gold Circle stores, formerly a division of Federated Department Stores, enabling Hills to expand its market penetration in New York, Ohio and Kentucky. Furthermore, it allowed Hills to capitalize on economies of scale in purchasing and merchandising. The total number of employees also increased 37.7% from 21,200 in 1985 to 29,200 in 1988 giving an annual employment growth rate of 11.3%. The Lee Company and management almost doubled the capital investment during the three years subsequent to the LBO compared to the three years prior. The company's annual sales growth since the LBO has been 17% versus an annual growth rate of 11% in prior years. The company's operating profits are currently 39% higher than before the LBO.

2) The second company, Boston-based J. Baker, Inc., is engaged in the retail sale of footwear through self-service licensed shoe departments in discount department stores. The company also supplies shoes on a wholesale basis and provides related merchandising services to two major mass merchandising department store operators. The company's licensed departments are located in 18 states in the Northeast, Midwest and Mid-Atlantic regions. Thomas H. Lee Company and management of J. Baker acquired the company in July 1985; at the time of our acquisition, the company generated $95 million of sales with approximately 1,700 employees. Since the buyout, the company has expanded its business through increasing its licensed sales and opening its own new stores. The company has completed two public offerings since the buyout and is currently traded OTC. As a result of its rapid growth, J. Baker now employs approximately 3,000 people, a 75% increase since the LBO, for a compound annual growth in employment of 17.5%. The company has grown from 580 stores

at the time of the buyout to 1,181 today. The company has on average spent $5 million a year since the management buyout to finance its growth, which is twice the amount prior to LBO.

We believe that part of the impetus for the buyout trend has been the unwinding of the conglomerate movement of the 1960s. The theory that a small group of financial managers could manage many disparate divisions and subsidiaries has not stood up well under close scrutiny. Many American corporations have found that without a core focus of key businesses which management can operate intensively, that corporate productivity and competitiveness suffers.

A large number of the transactions in which we become involved consist of these orphan divisions of large corporations which no longer fit into a core strategy. Additionally, we feel that the lack of ownership by managements of American corporations leads to bureaucratic inertia. LBO's are giving many managers who never would have had an opportunity otherwise to become owners of businesses. LBO's represent an investment in human resources. We think the re-entrepreneuring of America is just as important as the re-tooling. Every major American corporation started as a small enterprise run by an owner/operator who developed both the management and leadership capability necessary to business success. In a larger sense, since we never invest without being partners with management, we are facilitating the return to a focused owner/operator business environment. While we certainly are not against big business per se, you will find as you study the leveraged buyout markets that much of it revolves around the re-focusing of American businesses into more efficient operating units.

If buyouts were eliminated or impaired through adverse legislation, it would mean that the sellers of private companies would only be able to sell to other corporations. Typically, the acquisition of a company by another corporation results in layoffs and plant closings in the name of corporate efficiency. In the case of the acquisition of an entire company in a buyout, one needs to preserve all of the productive work force and virtually all of the plants involved in the operation. This would not be the case in large corporate consolidations, which would be the only remaining market if one were to eliminate buyouts as a mechanism for corporate divestiture.

Most of our transactions are financed with our own money and the capital of the Fund which we manage and in which we have a major personal economic interest. Having our own money at stake has a sobering influence on the risks we are willing to take. We understand well the problems of investing in a company whose management or products might not be able to withstand an economic downturn.

A number of our companies have been tested by the three severe recessions of the past fifteen years and have come through. Let me give you a brief recount of one of those, Hendrix Wire and Cable of Milford, New Hampshire.

Hendrix manufactures power cable for utility companies. This cable is used to distribute power to homes and new home sub-divisions. When interest rates went to 20% in the early 1980's our buyout was in serious trouble, both from the high cost of our floating rate debt and the impact of high rates on our customers. Our backlog and operating margins diminished dramatically. We were able to pull this company through, however, with an intensive two-year effort to improve the company's use of assets, including collecting receivables faster and reducing inventory. We convinced our suppliers to give us longer credit terms and we pared down our labor force on both a direct and indirect basis. We were able to create a much more efficient Hendrix. We have subsequently expanded the company's production capacity, and today Hendrix' sales are approximately $60 million, in contrast to the $16 million when we purchased it, and employment is substantially ahead of where it was at acquisition. I don't want you to think that pulling Hendrix through a recession was easy -- as a matter of fact, it involved extremely hard work and sleepless nights -- but it was a very severe recession for the company and its industry and we were able to weather that storm.

The popular press has spoken of the increase in the debt level in America. A study which we have attached based on Federal Reserve data compiled by Merrill Lynch has shown that aggregate debt level in the country has indeed risen from 110% of GNP in 1970 to 144% today. In that time, however, corporate debt in America has only risen from 35% of GNP to 37% of GNP, and we don't really see, from our own point of view, the need for an alarmist or extreme view on this point.

As you know, much of the senior debt in buyouts is supplied by banks. Many of the major banks in America have LBO specialists and specialized LBO departments, and these departments are staffed by people who intensively scrutinize every acquisition opportunity and who are as capable as we are at analyzing a company's future prospects. The professionalism of the major LBO lending banks is excellent. The banks in turn are closely scrutinized by the Federal Reserve, and indeed since Chairman Greenspan started to jawbone them following the announcement of RJR, you will find in our marketplace a distinct absence of anything like a feverish pace. Banks are very concerned today about the nature of their risk assets, and while they may be enjoying fee income from the financing of leveraged buyouts, their fear of loan losses is greater than their desire for fee income.

I think you should worry about what happens if you eliminate or impair LBO's. Companies for sale will only be sold to large corporations - frequently foreign - increasing concentrations of economic power, precipitating plant closing and job loss as part of the consolidation and, most importantly, eliminating the opportunity for talented managers to become owners.

I think you should also worry about the effect on the stock market. The availability of LBO pools of capital has put a safety net under stock prices. The fear of losing acquisition interest deductibility and its impact on LBO's contributed to the market crash in October 1987.

Paradoxically, I think you should also worry about the tax revenue impact of limiting LBO's. Much has been written about how LBO's are subsidized by the deductibility of interest on acquisition debt at a cost to the Treasury. Almost all of this ignores the capital gains taxes paid when a company is acquired, again when it is sold, and anytime there is a disposition of assets along the way. It ignores the secondary market effect on capital gains from stocks whose prices are higher because they are in the same industry as an LBO'd company or because the overall level of the market is higher. It ignores taxes paid on high interest bonds and bank loans used to finance LBO's. There should be serious study about whether LBO's reduce or increase tax revenue. It is hard to see how creating wealth for shareholders, bondholders and employees alike, which LBO's do, ultimately reduces tax revenue.

We strongly urge you not to create legislation which would adversely impact this vital part of the American capital markets.

Leveraged Buyouts in 1988 by Transaction Size
(dollars in millions)

Transaction Size	Number of Buyouts	Percent of Total	Cumulative Percent	Dollar Volume	Percent of $ Total	Cumulative Percent
Under $50 million	105	34.5%	34.5%	2,206.6	2.2%	2.2%
$50-$99.9 million	58	19.1%	53.6%	4,086.8	4.2%	6.4%
$100-$499.9 million	105	34.5%	88.2%	22,334.0	22.7%	29.1%
$500-$999.9 million	19	6.3%	94.4%	13,961.0	14.2%	43.3%
Over $1 billion	17	5.6%	100.0%	55,687.0	56.7%	100.0%
Totals	304	100.0%	100.0%	98,275.4	100.0%	100.0%

LBOs in 1988 without RJR Nabisco Inc.
(dollars in millions)

Transaction Size	Dollar Volume	Percent of $ Total	Cumulative Percent
Under $50 million	2,206.6	3.0%	3.0%
$50-$99.9 million	4,086.8	5.6%	8.6%
$100-$499.9 million	22,334.0	30.5%	39.1%
$500-$999.9 million	13,961.0	19.1%	58.1%
Over $1 billion	30,687.0	41.9%	100.0%
Totals	73,275.4	100.0%	100.0%

Published by Venture Economics, Inc.

MEMO

TO: Thomas H. Lee
For Kenneth Lehn, Chief Economist at SEC

FROM: Michael B. Hong, Mitchell S. Vance

SUBJECT: Summary on Public to Private LBO Analyses

DATE: January 23, 1989

Cumulative data for the period immediately preceding the public to private transactions of four (4) portfolio companies has been compared to the most recent fiscal year results of these companies. All four companies were taken private in the 1984 and 1985 calendar years making the pre/post LBO analysis comparable. Amerace Corporation was excluded from the study due to the break-up nature of the transaction subsequent to being taken private by First Boston which was prior to T.H. Lee's ownership. Highlights are as follows:

($000)

GROWTH IN:	APPROX. FOR 1984-1985 PRE-BUYOUT PRIOR OR AT PUBLIC TO PRIVATE TRANSACTION	APPROX. FOR 1988 POST-BUYOUT LATEST FYE RESULTS	APPROX. % GROWTH	APPROX. % ASSOCIATED WITH ACQUISITIONS
NET SALES	$2,167,229	$3,108,512	43%	3%
EBDITA(1)	$150,616	$ 214,489	42%	3.2%
CAPITAL & R&D EXPENDITURES	$47,388	$85,606	80%	12%
TOTAL # EMPLOYEES	37,987	43,031	13%	2.5%

(1) Earnings before depreciation, interest, taxes and amortization

THOMAS H. LEE COMPANY/PUBLIC TO PRIVATE TRANSACTION ANALYSIS
JANUARY 17, 1989

CHADCLIFF CORPORATION
(Chadwick Miller)

Fiscal Years Ending ($000)

	PUBLIC			PUBLIC TO PRIVATE TRANSACTION	PRIVATE			APPROXIMATE CAGR SINCE PUBLIC TO PRIVATE TRANSACTION
	12/31/81	12/31/82	12/31/83	10/3/84	3/31/86	3/31/87	3/31/88	
# Stores	N/A	16	18	18	31	35	39	
Net Sales	28,038	24,186	31,174	N/A	34,196	42,040	49,673	16%
EBDITA	3,816	2,312	3,924	-	4,209	5,069	5,703	13%
Capital Expenditures	143	541	594	-	873	1,211	1,553	38%
Total Debt/Net Worth	.29	.23	.30	-	4.65	4.0	3.16	
# Store Employees	N/A	-	-	211	331	383	461	
G & A Employees	N/A	-	-	26	34	44	46	
Total Employees(1)	N/A	-	-	287	415	475	552	24%

DEBT HOLDERS: (As of 1/15/89)	TYPES OF SECURITIES	$
Commercial Banks	Term, Mortgage, Revolving	$18,200
Finance Companies	Subordinated Debt	5,000
ML-Lee Acquisition Fund, L.P.	Subordinated Debt	15,000

COMMENTS:

Chadwick-Miller conducts its business through 2 separate divisions. The Retail Division operates 24 retail book stores under the Lauriat's name and 15 discount book stores under the Royal Discount Books name. The Import Division markets a broad range of novelty and giftware items imported form the Far East.

The Thomas H. Lee Company purchased Chadcliff Corporation on 10/31/84.

(1) Total includes other unclassified employees.

THOMAS H. LEE COMPANY/PUBLIC TO PRIVATE TRANSACTION ANALYSIS
JANUARY 17, 1989

J. BAKER, INC.
Fiscal Years Ending ($000)

	PUBLIC		PUBLIC TO PRIVATE TRANSACTION	PRIVATE				APPROXIMATE CAGR SINCE PUBLIC TO PRIVATE TRANSACTION
	1/28/84	2/2/85	7/9/85	2/1/86	1/31/87	1/30/88	1/31/89	
# Stores	535	546		581	771	1,105	1,181(1)	
Net Sales	78,788	95,186		126,677	165,796	200,680	250,000(1)	27.3%
EBDITA	5,947	7,774		9,378	16,168	17,847	NA	
Capital Expenditures ($000)	2,584	2,471		2,463	5,085	4,901	NA	
Total Debt/Equity				89.2	1.2	2.1	NA	
# Employees								
HQ Executive		131		152	193	234	292	
HQ Union		98		118	149	150	166	
Stores Union		1,248		1,520	2,127	2,675	2,452	
Total #		1,477		1,790	2,469	3,059	2,910	18.5%
Avg. Wage Rates ($)								
HQ Executive (weekly)		630.20		642.35	653.95	653.88	664.64	
HQ Union (hourly)		6.23		6.55	7.02	7.35	7.69	
Stores Union (hourly)		4.05		4.17	4.43	4.69	5.01	

DEBT HOLDERS (as of 10/29/88)	TYPES OF SECURITIES	AMOUNT ($000)
Commercial Banks	L/C & B/A Financing(2)	52,400
Insurance Company	Senior Term & Revolver	21,025

COMMENTS:

J. Baker is engaged in the sale of footwear as an operator of licensed shoe departments in mass merchandising department stores, as a supplier of shoes at wholesale and related merchandising services to mass merchandising department store operators, and as an operator of "one price" shoe stores in the Company's Parade of Shoes and Step In Shoes chains.

(1) Estimates (2) Fluctuates with business cycle

THOMAS H. LEE COMPANY/PUBLIC TO PRIVATE TRANSACTION ANALYSIS
JANUARY 17, 1989

HILLS DEPARTMENT STORES

Fiscal Years Ending ($000)

	PUBLIC			PUBLIC TO PRIVATE TRANSACTION	PRIVATE				APPROXIMATE CAGR SINCE PUBLIC TO PRIVATE TRANSACTION
	12/29/83	1/28/84	1/26/85	12/10/85	1/25/86	1/31/87	1/30/88	1/31/89(4)	
# Stores			123		125	137(3)	152	202	
Net Sales	1,155,051	1,304,579	1,423,613		1,483,600	1,343,102	1,514,329	1,672,000(2)	4.1%
Operating Profit bef. Nonrecurring Inventory Charge	66,981	80,872	84,760		86,389	94,412	103,535	103,000(2)	5.0%
Capital Expenditures	32,015	36,983	24,380		13,154	27,062	46,897	75,000 (2)	
Total Debt/Net Worth					7.4	7.0	34.7		
# Employees									
Management					1,741	1,878	2,152	2,447 (1)	
Hourly					20,484	20,896	21,635	23,122 (1)	
Total #					22,225	22,774	23,787	25,569	4.8%
Avg. Hrly. Wage ($)									
Management					$21.10	24.80	24.40	24.50 (2)	
Hourly					5.03	5.74	5.99	NA	

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DEBT HOLDERS	TYPES OF SECURITIES	AMOUNT
Commercial Banks (as of 1/16/89)	Revolver	75,000 145,000
Insurance Companies	Sr. Notes, Sr. Sub Notes Sub. Notes, Pfd. Stock Common Stock	172,130
Savings & Loans	Sr. Notes, Sr. Sub. Notes Sub. Notes, Pfd. Stock Common Stock	11,838
Pension Funds	Sr. Notes, Sr. Sub. Notes Sub. Notes, Pfd. Stock Common Stock	8,913
Other	Sr. Notes, Sr. Sub. Notes Sub. Notes, Pfd. Stock Common Stock	110,209

COMMENTS

Hills Department Stores, Inc. is a leading regional discount retailer offering a broad range of brand name and other first quality general merchandise. The Company's stores are located in 13 states in the eastern and central regions of the U.S.

The Thomas H. Lee Company acquired Hills on December 11, 1985.

(1) As of the end of third quarter of FY 1988
(2) Estimates
(3) During FY 86, the Company sold Retail Footwear for $42.5 million, The Dry Goods for $13 million and SCA International for $4.2 million. All of these divestitures were made because of incompatability within the strategic focus of the Company.
(4) In September 1988, the Company acquired 35 Gold Circle stores to expand its market penetration in New York, Ohio and Kentucky.

THOMAS H. LEE COMPANY PUBLIC TO PRIVATE TRANSACTION ANALYSIS
JANUARY 17, 1989

COLE NATIONAL CORPORATION

Fiscal Years Ending ($000)

	PUBLIC				PUBLIC TO PRIVATE TRANSACTION	PRIVATE				APPROXIMATE CAGR SINCE PUBLIC TO PRIVATE TRANSACTN
	1/30/81	1/30/82	1/30/83	1/30/84	9/17/84	2/2/85	2/1/86	1/31/87	1/30/88	
# of Stores						1,629	1,764	1,827	1,955	
Net Sales	173,992	407,662	500,319	617,256		686,325	780,800	928,357	1,136,839	18.3%
EBDITA	N/A	34,832	30,545	54,158		57,161	71,759	74,798	87,939	15.4%
Capital Expenditures	N/A	12,978	11,589	19,943		24,721	20,902	28,540	32,315	
Total Debt/Net Worth	N/A	N/A	1.81	1.91		3.85 (2)	N/A (1)	4.18	N/A	
# Store Employees	N/A	N/A	N/A	8,450		9,404	10,134	11,390	12,297	
#G&A Employees				1,250		1,703	1,346	1,366	1,610	
Total Employees				9,700		10,750	11,500	13,000	14,000	9.6%

DEBT HOLDERS (As of 1/16/89)	TYPES OF SECURITIES	COMMITTMENT $
Commerical Banks	Revolving, Working Capital	$375,000
	IRBs	8,900
Insurance Company	Senior Sub Notes	148,578 (carrying value)
Savings & Loans	Junior Sub Notes	56,000
Insurance Companies	Junior Sub Notes	13,100
Pension Funds	Junior Sub Notes	15,000
Investment Banks	Junior Sub Notes	5,000
Other Investors	Junior Sub Notes	10,900
Management, T.H. Lee Company & Institutional Investors	Redeemable Pfd. Stock (Series A & B)	113,106

COMMENTS

The Company operates several specialty retail businesses under names like Child World, Inc., Cole Vision, Cole Eyeworks, Things Remembered, Cole Key and French Oven.

Starting with 1,827 stores as of 1/31/87, the company opened 128 new stores in 1987. The Company plans to open additional 176 stores in 1988. On January 31, 1989, store count will total 2,131.

The Thomas H. Lee Company purchased Cole National on 9/4/87.

NOTES ON ACQUISITION & DIVESTITURES

(1) Cole National acquired Eyelab, Inc. in 12/86 to supplement its existing Eyeworks Stores. Operating Statistics since acquisition:

	FYE 1/30/88
Sales	56,052
EBIT	4,931
Capital Expenditures	5,772
# of Employees	975

(3) Total includes other unclassified employees

(2) Cole National Sold The Original Cookie Company in 3/85 for an offer substantially in excess of perceived value. Operating statistics prior to acquisition:

	FYE 2/2/85
Sales	30,694
EBIT	3,426
Capital Expenditures	3,625
# of Employees	1,005

THOMAS H. LEE COMPANY/PUBLIC TO PRIVATE TRANSACTION ANALYSIS
JANUARY 17, 1989

AMERACE CORPORATION

Fiscal Years Ending ($000)

	PUBLIC			PUBLIC TO PRIVATE TRANSACTION	PRIVATE				APPROXIMATE CAGR SINCE PUBLIC TO PRIVATE TRANSACTION
	12/31/82	12/21/83	11/1/84	11/1/84	10/31/85	10/31/86	10/31/87	10/31/88	
Net Sales	247,502	265,880		155,109	140,778	150,582	211,053	244,536	12%
EBDITA	15,493	26,053		30,044	31,035	30,986	36,096	N/A	N/A
R&D Expenditures	6,973	8,788		6,295(3)	5,071	5,592	5,509	5,700	
Capital Expenditures	7,175	6,811		4,821	6,747	5,826(4)	7,320(5)		
Total Debt/Net Worth	.74	.80		21.3	14.4	14.6	N/A	N/A	
			(3)			(1)	(2)		
# Hourly - Non-Union		1,390		1,465	871	810	797	994	
Hourly - Union		1,469		1,350	96	110	256	277	
Salaried		1,439		1,370	682	648	663	680	
Total Employees		4,298		4,185	1,649	1,568	1,716	1,971	
Average Hourly Wage		7.87		8.04	8.21	8.63	8.87	9.09	

DEBT HOLDERS	TYPES OF SECURITIES	AMOUNT ($000)
Commercial Banks	Term, Revolver, IRB	24,428
Drexel Public Bonds	Senior Sub. Notes	84,100
Finance Companies	Term Notes	700
Sub. Debt Funds (ML-Lee Acquisition Fund L.P.)	Jr. Sub. Notes	30,000

COMMENTS

Amerace is a leading manufacturer of electrical components and highway safety products.

The Thomas H. Lee Company made its first investment in Amerace in June, 1986. A follow on investment was made with the ML-Lee Acquisition Fund in February of 1988.

ACQUISITION & DIVESTITURE NOTES

(1) Amerace acquired Conductron in 10/86 congruent with a strategy to growth through acquisition. Conductron's annual impact during its first full year of operation:

	10/31/87
Sales	48,164
EBIT	2,387
R&D Expenditures	0
Capital Expenditures	690
# Employees	161

(2) Amerace acquired Russellstoll in 4/87 for the same strategic reason as Conductron. Russellstoll's annual impact in its first full year of operation:

	10/31/88
Sales	30,138
EBIT	3,852
R&D Expenditures	830
Capital Expenditures	N/A
# Employees	249

(3) Amerace divested three companies in 1985. Their impact for the last full year of operations:

	Sales	EBIT	R&D Exp.	# Employees
Custom Molded Products Division Date Divested: 10/85	17,290	<2,040>	257	411
Esna & Caco -Pacific Division Date Divested: 4/85	42,025	1,195	974	618
Anchor Swan Date Divested: 1/85	87,318	5,018	1,421	1,437
Totals	146,633	8,253	2,652	2,466

Had expenditures associated with the three divested companies been added, the total R&D expenditures would have been $8,947,000 for YE 11/1/84

(4) Excludes capital expenditures for the acquisition of Conductron of $14,650

(5) Excludes capital expenditures for the acquisition of Russellstoll of $26,252

SELECTED PORTFOLIO COMPANIES FOR THE PERIOD 1980-87

Company Name	Closing Date	Fiscal Year End	($000) Annual Sales (at Closing)	Est/Act. Annual Sales (Most Recent)	Sales Compound Annual Growth Rate	GNP Growth (Comparable Period)	Comments
Guilford Industries, Inc. (Guilford, Maine)	3/29/82 sold in 12/86	3/31	$40,838 (YE 1/31/82)	$74,784 (YE 3/30/86)	16.3%	7.1%	Guilford is a leading designer, marketer and integrated manufacturer of specialty fabrics used in the office interiors industry. The Company entered this market in 1975, and has since established itself as the leading supplier of panel fabrics for the open plan office furniture systems and interiors markets. Because the open plan concept offers many advantages over conventional office designs, including more efficient floor space utilization, reduced energy consumption and greater flexibility to redesign existing space, the open plan office systems market has grown rapidly during the 1980's. Thomas H. Lee Company continued and enhanced the growth of this company throughout the early and mid 1980's.
	Total No. of Employees		1,180 as of 3/82	1,490 as of 12/86	26.3%		
	Capital Expenditures		The Company mande an annual capital expenditure of $7.8 MM after LBO whereas its annual capital expenditure was $2.7 MM between 1979-81.				
Chadwick-Miller, Inc. (Canton, Mass.)	10/3/84	3/31	$30,505 (YE 3/31/85)	$53,500 P (YE 3/31/89)	15.1%	6.3%	Chadwick-Miller conducts its business through 2 seperate divisions. The Retail Division operates 24 retail book stores under the Lauriat's name and 15 discount book stores under the Royal Discount Books name. The Import Division markets a broad range of novelty and giftware items imported from the Far East. The number of Lauriat's and Royal stores increased from 18 at the time of acquisition to 39 today.
	Total No. of Employees		287 as of 10/84	611 as of 12/88	212.0%		
	Capital Expenditures		$1.3 MM total capital investment between 1981 and 1983. $3.6 MM total investment between 1985 and 1987.				
Sterling Inc. (Akron, Ohio)	6/25/85 sold in 8/87	1/31	$59,318 (YE 1/26/85)	$100,419 (YE 1/25/87)	30.1%	6.0%	Sterling Inc. is a specialty retailer of fine jewelry. The Company's stores are located predominantly in enclosed regional shopping malls concentrated in the West, Midwest and Mid-Atlantic regions, including Ohio, Michigan, Wisconsin, Minnesota, California and West Virginia. The company operates its stores under the names of Shaw's Jewelers, LeRoy's Jewelers, Sterling Jewelers, Hudson-Goodman Jewelers, Goodman Jewelers and Friedlander Fine Jewelers. The number of stores increased dramatically from 75 at the time of closing to 114 for the year ended 1/25/87.
	Total No. of Employees		850 as of 6/85	1,335 as of 7/87	57.1%		
	Capital Expenditures		$2.1 MM for YE 1/86 $7.7 MM per year on avg. after LBO				

Company Name	Closing Date	Fiscal Year End	Annual Sales (at Closing)	Est/Act. Annual Sales (Most Recent)	Sales CAGR	GNP Growth (Comparable Period)	Comments
J. Baker, Inc. (Hyde Park, Mass.)	7/10/85	1/31	$95,186 (YE 2/2/85)	$250,000 P (YE 1/30/89)	27.3%	6.3%	J. Baker is engaged in the sale of footwear as an operator of licensed shoe departments in mass merchandising department stores, as a supplier of shoes at wholesale and related merchandising services to mass merchandising department store operators, and as an operator of "one price" shoe stores in the Company's Parade of Shoes and Step in Shoes chains. The Company's licensed deaprtments are operated under license from Ames Department Stores, Inc., a major mass merchandising retailer in the Northeast and from Fishers Big Wheel, Inc., a large chain concentrated in Michigan, Ohio and Pennsylvania. The Company supplies footwear at wholesale and related merchandising services to two major department store chains--Gold Circle and Pamida Stores, Inc. It also operates Parade of Shoes stores located in New England. The number of stores increased dramatically from 580 at the time of buyout to 1181 stores as of 1/89.
	Total No. of Employees		1,700 as of 7/85	3,000 as of 12/88	76.5%		
	Capital Expenditures		$2.5 MM per year on avg. prior to LBO (CY 83-84) $5.0 MM per year on avg. after LBO (CY 86-87)				
Hills Department Stores, Inc. (Canton, Mass.)	12/10/85	1/31	$1,213,700 (YE 1/25/86)	$1,672,000 P (YE 12/31/88)	11.3%	6.2%	Hills is a leading regional discount retailer with stores located in 13 states in the eastern and central regions of the United States, including Pennsylvania, Ohio, Indiana, New York, Michigan, Tennessee, Virginia and West Virginia. Although Hills opened only 2 stores in the year prior to LBO, it opened 12 stores in 1986 and 15 stores in 1987. In October 1988, Hills acquired 35 Gold Circle stores to expand its market penetration in New York, Ohio and Kentucky. Total number of stores owned as of 1/30/89 will be 202.
	Total No. of Employees		21,200 as of 12/85	29,200 as of 12/88	37.7%		
	Capital Expenditures		$26.6 MM per year on avg. (1982-85) $49.7 MM per year on avg. (1986-88)				
Amerace Corporation (Parsippany, NJ)	7/2/86	10/31	$150,582 (YE 10/31/86)	$244,536 (YE 10/31/88)	27.4%	6.8%	Amerace is a leading manufacturer of electrical components and highway safety products. The Company acquired Conductron Corporation in October 1986 and the Russellstoll Division of Midland-Ross Corporation in April 1987 which extended and complemented existing product lines, provided opportunities to streamline the manufacturing process and added to the strength of Amerace's management.
	Total No. of Employees		1,189 as of 7/86	1,771 as of 11/88	48.9%		
	Capital Expenditures		An annual capital investment of app. $7.2 MM prior to the Lee Company's involvement in the Company. Since July 1986, the Company spent $62.8 MM in capital investment through acquisitions and purchase of machinery & equipment.				
Cole National Holding (Cleveland, Ohio)	9/4/87	1/31	$928,357 $ 74,798* (YE 1/31/87)	$1,247,296 Est. $ 105,131* Est. (YE 1/31/89)	15.9% 15.4%	6.8%	The Company operates several specialty retail businesses under names like Child World, Inc., Cole Vision, Cole Eyeworks, Things Remembered, Cole Key and French Oven. Starting with 1,827 stores as of 1/31/87, the company opened 128 new stores in 1987. The Company plans to open additional 176 stores in 1988. On January 31, 1989, store count will total 2,131.
	Total No. of Employees		13,000 as of 1/87	15,060 as of 1/89			
	Capital Expenditures		$19.8 MM per year on avg. prior to THL's LBO (CY 1981-86) $36.2 MM per year on avg. after THL's LBO (CY 1987-88)				

* Operating Income (Earnings before Interest, Taxes, Depreciation & Amortization)

Company Name	Closing Date[1]	Fiscal Year End	Annual Sales (at Closing)	Est/Act. Annual Sales (Most Recent)	Sales CAGR	GNP Growth (Comparable Period)	Comments
Health o meter, Inc. (Bridgeview, IL)	4/28/88	12/31	$24,581 (YE 12/31/87)	$31,800 (YE 12/31/88)	29.4%	7.0%	Health o meter is a manufacturer of people-weighing scales and other ancillary products. The Company is dominant in the upright scale segment with 87% of the market--the industry segment with the highest margins and greatest growth potential. Since the acquisition of the Company, it has opened new accounts with such customers as J.C. Penney and Sears.
	Total No. of Employees		253 as of 4/88	279 as of 12/88	10.3%		
	Capital Expenditures		$239,000 per year on avg. prior to LBO $350,000 in 1988				
Corhart Refractories Corp. (Louisville, KY)	5/85 (sold in 7/87)	3/31	$63,453 (YE 12/31/84)	$60,003 (YE 3/31/87)	NA	6.0%	Corhart is a manufacturer of specialty, high-performance refractories used in glass and metallurgical melting applications. Corhart's business had been historically cyclical even before the acquisition by TRL Co., although the Company has maintained profitable operations and positive cash flow through all phases of the business cycle. The Company closed down a plant supplying to the steel industry.
	Capital Expenditures		$2.1 MM per year on avg. for 3 years prior to LBO the same level of capital expenditures after LBO.				
Carlin Foods Corp. (Chicago, IL)	7/83 (sold in 7/87)	3/31	$58,900 (YE 3/31/83)	$80,111 (YE 12/31/86)	8.5%	7.6%	Carlin Foods Corp., formerly three divisions of Mallinckrodt, is a manufacturer and marketer of specialty ingredients and systems to the food industry. The Company has four plants in Seattle, Washington;Englewood, New Jersey;and Gardina, California. The Company expanded its business by broadening geographic markets it serves.
	Total No. of Employees		350 as of 7/83	420 as of 7/87	20.0%		
	Capital Expenditures		$510,000 per year on avg. between 1977 and 1982 $1.6 MM per year on avg. after LBO				
Federal Communications Corp. (East Providence, RI)	1/84 (sold in 12/86)	12/31	$3,127 (YE 12/25/83)	$6,520 (YE 12/31/86)	27.8%	7.6%	Federal Communications Corp. was formed to acquire 2 AM/FM broadcast properties in Providence, Rhode Island. In July, 1985, Federal Communications also acquired 2 Louisville, Kentucky radio properties. The investment strategy was to acquire and build a group of broadcast properties.
O'Donnell-Usen Fisheries Corporation (Boston, Mass.)	12/83 (sold in 5/87)	12/31	$82,444 (YE 12/31/83)	$94,173 (YE 12/31/86)	4.5%	7.6%	Based in Boston, Massachusetts, O'Donnell-Usen consists of a group of companies which constitute an integrated manufacturer and marketer of frozen fish products, including trawler operations, filleting plants and processing and packaging operations. The Company expanded its business by introducing new packaging and developing new product lines such as microwavable products. Its operations are located in Massachusetts and Maine.
	Total No. of U.S. Employees		439 as of 12/83	464 as of 12/86	5.7%		
	Capital Expenditures		no significant capital investment in the company prior to LBO. $1.9 MM capital investment in the company since LBO.				
Miller Import Corp. (Brooklyn, New York)	10/82	5/31	$11,666 (YE 5/31/82)	$16,564 (YE 5/31/88)	6.0%	7.4%	Miller Import Corp. is an importer and merchandiser of leaded glass crystals and porcelain figures, primarily from Germany and Italy. The Company's business growth was accomplished by an expansion of the Company's product lines and the development of brand names recognized in the trade.
	Total No. of Employees		52 as of 5/82	56 as of 12/88	7.7%		
	Capital Expenditures		$108,000 per year on avg. prior to LBO $139,000 per year on avg. since LBO				

Company Name	Closing Date	Fiscal Year End	Annual Sales (at Closing)	Est/Act. Annual Sales (Most Recent)	Sales CAGR	GNP Growth (Comparable Period)	Comments
Merson-Marvel (Chelsea, Mass.)	5/5/87	12/31	$44,861 (YE 12/31/86)	$50,500 P (YE 12/31/88)	6.1%	6.8%	Merson is a manufacturer and supplier of automotive products primarily for the professional and consumer aftermarkets. Marvel is a manufacturer and supplier of specialty incandescent and fluorescent light bulbs. The Company has increased its business through the expansion of product lines and market penetration while it modernized its operation by acquiring new equipment.
	Total No. of Employees		408 as of 5/87	394 as of 11/88	-3.4%		
	Capital Expenditures		$755,000 in FY 86 (YE 12/31/86) $750,000 in FY 88 (YE 12/31/88)				
Image Carpets, Inc. (Armuchee, GA)	6/30/87	6/30	$53,576 (YE 12/31/86)	$69,783 (YE 7/1/88)	10.8%	6.8%	Image Carpets is a vertically integrated manufacturer of residential and commercial carpet. The Company enjoys a strong niche position with innovative, value oriented products in a highly competitive market. The Company is currently building a new spinning mill in Alabama which is expected to begin its operation by the end of 1989. It is anticipated that the new plant will create about 160 new jobs.
	Total No. of Employees		789 as of 6/87	840 as of 12/88	6.5%		
	Capital Expenditures		$2.81 MM for YE 12/31/86 $6.75 MM for YE 6/30/88				
Panache Broadcasting Corporation (Philadelphia, PA)	3/18/87 (sold in 12/88)	12/31	$8,072 (YE 12/31/86)	$10,600 P (YE 12/31/88)	14.6%	6.8%	Panache consists of four broadcast properties including WWDB-FM, Philadelphia; WBLZ-FM, Cincinnati; and WTUX-AM/WTLC-FM, Indianapolis. It sold WBLZ station in 10/88 for $7.8 million to William Dalton Group, Inc.
	Total No. of Employees		175 as of 3/87	125 as of 12/88	-28.6%		
	Capital Expenditures		$100,000 in the first two years of LBO; the first significant capital investment in the Company since the early 1980's				
Autotote Systems, Inc. (Newark, Delaware)	1979	6/30	$23,669 (YE 6/30/79)	$37,000 P (YE 6/30/89)	4.6%	7.7%	Autotote designs, engineers, manufactures, markets and operates computerized wagering systems, commonly referred to as totalisators. These systems, which include proprietary software programs, are used at horse and greyhound racetracks throughout North America, South America and Europe.
	Total No. of Employees		323 in 6/79	319 in 12/88	-1.2%		
	Capital Expenditures		$38.4 MM capital investment in the Company since 1982.				
Alliance International Group, Inc. (Norcross, GA)	12/31/87	12/31	$39,700 (YE 12/31/87)	$41,900 (YE 12/31/88)	5.50%	NA	Alliance is the leading producer of light gauge, porcelain enamel on steel (PES) surfaces. PES surfaces are used principally as the base material for writing boards and as interior and exterior walls. PES is growing in writing surface and architectural applications because of its extreme durability, cleanability, resistance to heat and chemicals, and general ease of maintenance.
	Total No. of Employees		154 as of 12/87	160 as of 12/88	3.90%		
	Capital Expenditures		$500K per year on avg. prior to LBO $250K in FY 88 (YE 12/31/88). The Company plans to spend appr. $1.7 MM in 1989 to consolidate the U.S. manufacturing operations, expand the U.S. sales effort, and invest in technological improvements.				

Company Name	Closing Date	Fiscal Year End	Annual Sales (at Closing)	Est/Act. Annual Sales (Most Recent)	Sales CAGR	GNP Growth (Comparable Period)	Comments
First Security Services Corporation (Boston, Mass.)	12/31/85	12/31	$32,000 (YE 12/31/85)	$47,000 (YE 12/31/88)	17.6%	6.2%	First Security provides guard services to facilities located in the Northeast of the United States, including Massachusetts, Connecticut, New York and New Hampshire. Founded in 1973, it is one of the fast growing security service companies in the U.S.
	Total No. of Employees		2100 as of 12/86	2900 as of 12/88	38.1%		
	Capital Expenditures		Total of $1.3MM in the Company since LBO in 12/85 which is consistent with the pre-LBO level.				
Black Oak Industries, Inc. (Shepard Clothing) (New Bedford, Mass.)	6/86	12/31	$45,653 (YE 9/30/85)	$48,749 (YE 12/31/88)	3.0%	6.2%	Black Oak Industries designs, manufactures and markets men's tailored clothing consisting of private label sport coats and suits. Through company salesmen, the Company sells products to a broad customer base comprised of major department stores, men's specialty stores, general merchandise chains, discount outlets and catalogue houses.
	Total No. of Employees		835 as 6/86	886 as of 12/88	6.1%		
	Capital Expenditures		$242,000 in FY 1985 (YE 12/31/85) $294,000 per year since LBO				
TOTAL SALES GROWTH					14.50%	6.5%	
TOTAL EMPLOYMENT GROWTH		at the time of LBO: 45,284		most recent: 59,250	30.8%		

P: Preliminary

*This chart does not include two small transactions, Dolfin Corporation and Kelley Manufacturing Co. Dolfin grew significantly but underwent a major restructuring. Kelley liquidated due to pressures caused by the Houston building depression and foreign import competition.

SIGNIFICANT INVESTMENTS MADE BY THOMAS H. LEE COMPANY AND ITS AFFILIATES IN 1988

Magicsilk Corporation (Roonachie, NJ)
ATP Holdings Corporation (New York, NY)
Petco Animal Supply Supermarkets (Los Angeles, CA)
Duro-Test Corporation (North Bergen, NJ)
BeefAmerica, Inc. (Omaha, Nebraska)
American Health Companies, "The Diet Centers" (Rexburg, Idaho)
Stanley Interiors Corporation (Stanleytown, Virginia)
Playtex Family Products Corporation (Stamford, Conn.)
Command Communications, Inc. (New York, NY)
Omega Wire, Inc. (Williamstown, New York)
New England Alpine Ski Shop, Inc. (Warwick, Rhode Island)

Debt Levels

Although total debt has risen steadily over the past two decades, corporate debt is not the main cause of the rise in debt. Corporate debt in 1988 made up a smaller portion of total debt than it did in the 1970's, while both Federal debt and Household debt made up larger portions of total debt, as the table below shows.

Total Debt

	1970	1975	1980	1985	1988
Corporate	32%	31%	28%	26%	26%
Federal	26%	25%	24%	30%	30%
Household	42%	44%	48%	44%	44%

Even when measured as a percent of gross national product corporate debt has not risen as dramatically as federal and household debt have risen relative to the size of the economy. As the table below shows, while total debt as a percentage of GNP has risen over the past two decades, corporate debt as a percentage of GNP is only slightly higher than it was in 1970, while federal and household debt are considerably higher.

Debt As % of GNP

	1970	1975	1980	1985	1988
Total	110%	107%	109%	131%	141%
Corporate	35%	33%	30%	33%	37%
Federal	29%	27%	27%	40%	42%
Household	48%	47%	52%	58%	62%

High-Yield Debt

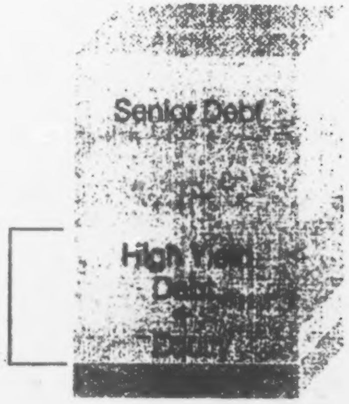
Although high-yield debt has grown rapidly in the last few years, it constitutes a very small percentage of total debt in our economy. As the table below shows, high-yield debt in 1988 consituted only 3 percent of total debt.

	Amount (in Billions)	% of Total
Total Debt	$6,732	100%
Household Debt	2,937	44%
Federal Debt	2,013	30%
Corporate Debt Other than High-Yield	1,594	23%
High-Yield Debt	187	3%

Source of Data: Merrill Lynch Economics

Thomas H. Lee Company

Financing a Leveraged Acquisition



Senior Debt

High Yield Debt

Equity

Mezzanine Financing

Investing in Middle Market Growth Companies

Thomas H. Lee Company

and

ML-Lee Acquisition Fund, L.P.

$690,000,000 of Mezzanine Financing since December 31, 1987

$19,850,000 **ALLIANCE INTERNATIONAL GROUP, INC.** $17,750,000 Subordinated Notes $2,100,000 Common Stock December 1987 *Leading producer of porcelain enamel on steel surfaces*	**$39,982,353** **AMERACE CORPORATION** $30,000,000 Subordinated Notes $5,000,000 Preferred Stock $4,950,000 Common Stock $32,353 Common Stock Warrants March 1988 *Leading producer of electrical components and highway safety products*	**$15,565,706** **MAGICSILK CORPORATION** $15,305,000 Senior Subordinated Notes $260,706 Convertible Preferred Stock April 1988 *Largest designer, importer and distributor of artificial flowers & plants in the United States*	**$17,520,000** **HEALTH O METER CORPORATION** $16,000,000 Subordinated Notes $1,520,000 Common Stock April 1988 *Leading manufacturer of professional and bathroom scales*	**$16,000,000** **ATP HOLDINGS CORPORATION** $16,000,000 Senior Subordinated Notes Common Stock Warrants May 1988 *Leading manufacturer of embroidery, buttons and labels in the United States*	**$26,513,514** **DURO-TEST CORPORATION** $25,000,000 Subordinated Notes $1,513,514 Common Stock August 1988 *Manufacturer and marketer of premium quality long life and energy-efficient light bulbs*	**$117,000,630** **BEEFAMERICA, INC.** $55,000,000 Senior Bridge Notes $40,000,000 Subordinated Notes $20,000,000 Senior Subordinated Interim Notes $2,000,000 Common Stock Common Stock Warrants September 1988 *Fourth largest beef packing company in the United States*
$57,666,667 **DIET CENTER** $46,666,667 Subordinated Notes $7,333,333 Preferred Stock $3,666,667 Common Stock September 1988 *A leading provider of weight loss services and products*	**$53,600,000** **STANLEY INTERIORS CORPORATION** $20,000,000 Senior Bridge Notes $30,000,000 Subordinated Notes $3,600,000 Common Stock September 1988 *Leading wood furniture manufacturer*	**$19,655,407** **PETCO ANIMAL SUPPLY SUPERMARKETS** $9,500,000 Senior Subordinated Notes $92,500 Common Stock July 1988 $5,000,000 Bridge Notes $5,000,000 Subordinated Notes $62,907 Common Stock November 1988 *Leading specialty retailer of pet foods and supplies*	**$16,200,000** **CHADWICK-MILLER INCORPORATED** $15,000,000 Senior Subordinated Notes $1,200,000 Common Stock December 1988 *The leading independent and discount book store operator in New England*	**$16,826,000** **OMEGA WIRE, INC.** $15,000,000 Senior Subordinated Notes $1,506,000 Pay-In-Kind Cumulative Preferred Stock $320,000 Common Stock December 1988 *Second largest manufacturer of non-insulated copper wire and cable products in the United States*	**$111,000,000** **PLAYTEX FAMILY PRODUCTS CORPORATION** $90,000,000 Subordinated Notes $15,000,000 Preferred Stock $6,000,000 Common Stock December 1988 *Leading worldwide producer and marketer of branded packaged consumer products*	**$163,250,000** **OF** **MEZZANINE, BRIDGE** **AND** **RELATED INVESTMENTS** **IN OTHER** **TRANSACTIONS**

Thomas H. Lee Company

Thomas H. Lee Company is a Boston based private investment firm. Its affiliate, ML-Lee Acquisition Fund, L.P., is a public investment partnership which invests primarily in mezzanine debt and equity securities in friendly acquisitions and recapitalizations.

One Boston Place, Boston, MA 02108 (617) 227-1050

Mr. GIBBONS. Thank you.

Mr. Manor.

STATEMENT OF MICHAEL H. MANOR, PRESIDENT AND CHIEF FINANCIAL OFFICER, CHIEF AUTO PARTS, INC., SEAGOVILLE, TX

Mr. MANOR. Thank you, Mr. Chairman.

I thank you and the members of the committee for giving me this opportunity to tell our story here today.

I am Michael Manor, and the president and chief executive officer of Chief Auto Parts, which is an auto parts retailer based in Dallas, TX.

We are currently operating 482 stores in nine states, and we employ just over 4,600 people, primarily in the Sunbelt part of the country.

For the past 9 years, my company was part of the Southland Corp., and, as of last April, with management and Shearson, Lehman, Hutton working together, we purchased Chief Auto Parts from the parent company, and to bring the deal to foreclosure the rest of the funds necessary for the deal were provided by General Electric Capital Corp., and there were no junk bonds involved. We were an asset sale, and at the time of the close of the deal, the total value of the assets was in excess of the purchase price.

At the time we closed the deal, we incurred approximately $133 million in debt, and at that time I reorganized the company and eliminated 41 redundant management positions; and from April last year we opened 16 new stores, we increased our total workforce by about 300 employees. We have been realizing same store sales increases, in excess of 10 percent, and while making all of our interest payments on our debt, we have been able to reduce our debt by just over $13 million this year.

The interesting thing for us is that if the LBO scenario had not been available we would have been faced with being purchased by one of three of our competitors, one of them being a foreign company, and those issues have already been discussed.

If either of the other two competitors had purchased us, we were sharing substantial markets with them, primarily in the Western states, and we estimate that somewhere around 20 percent of our stores would have been closed—theirs and ours—if we had been purchased by one of them, and approximately 800 to 900 positions would have been eliminated.

So, in this specific case, the LBO alternative was a much more desirable option for us than to be swallowed up by a competitor.

On the surface, one would probably think that our story was more the exception than the rule. From the things that I have heard and read, that is not necessarily the case. There is a tendency for us to hear and read about the more spectacular negatives, and the more sensational things involve the LBO's that are improperly managed, or ill-conceived at the onset.

There was a question asked a little bit earlier, I believe, by Mr. Moody, if there is such a thing as a good LBO or a bad LBO; and I don't believe that there is any distinction. I think that there is good management and bad management.

And my main concern is that if the Government decides to get involved in further regulating the LBO process, that it is highly unlikely that this involvement will make good management out of poor, or bad, management; and it is also quite likely that the involvement will limit, or restrict, or eliminate options that are currently available to good management.

Therefore, my recommendation is that the Government not get any further involved and, at the risk of what I have heard in earlier testimony of making a recommendation, I would say in the final analysis that if this committee feels that the Government needs to get more involved in the LBO process, then perhaps consider incorporating in some future legislation a management principle that we used to guide our company.

Simply stated, it says, "What gets rewarded gets done." And if we are going to do something to further regulate the LBO's, then consider finding some way of rewarding management teams in a meaningful way for not overpaying for their company and for not taking on unrealistic debt, for not dismantling their companies, selling off assets, and displacing hundreds, if not thousands of workers.

If we are taking positive action to improve their existing operation and pay down debt ahead of schedule, if it is necessary to get involved and we take that approach, then I think that the LBO process will continue to stay a very positive and powerful tool in American business.

Thank you.

[The statement of Mr. Manor follows:]

Michael H. Manor - Chief Auto Parts Inc.
Testimony
House Ways and Means Committee

Mr. Chairman and members of the Committee, my name is Michael Manor and I am the President and Chief Executive Officer of Chief Auto Parts, an automotive parts retailer based in Dallas, Texas.

I want to thank the Committee for allowing me to testify here today on how a management-led leveraged buyout made Chief Auto Parts a healthier, more competitive company. Let me add at the outset that I applaud the Committee's case study approach. In talking to managers who have been involved in a leveraged buyout, you find that the facts of a particular transaction rarely square with the conventional wisdom on the subject. Such is the case for Chief Auto Parts.

I'm here to tell you today that the current success story that is Chief Auto Parts would not have been possible without our management-led leveraged buyout almost one year ago.

The bottom line is that without the ability for management to purchase the company, Chief would have most likely been engulfed by one of its competitors with eyes on expanding its markets. It was clear to us from the offers of purchase that such a move would result in a dismantling of Chief Auto Parts, resulting in layoffs of some 1,000 employees and the closure of up to 25 percent of our stores. It was our opinion that creating a less competitive marketplace helped no one -- customers, vendors and employees alike.

And the fact of the matter is, our LBO was the best move to make. Not only has Chief remained intact, but today it is a more viable, competitive and healthier company than it has ever been. Since our LBO, we have opened 16 new stores and brought in 300 new employees. And our plans are for continued growth.

But, before I continue on our current plans, it may be valuable to go over some of the company's history to put things into perspective and show you how we got to where we are today.

Since 1979, Chief Auto Parts has operated as a division of The Southland Corporation, contributing about 3.5 percent of the company's gross revenues. Southland reaped the lion's share of its profits from its core business, the nationwide chain of 7-Eleven Stores.

Chief was a small division in a large company, with attention and resources diverted to other businesses. The "little fish in the wrong pond" problem made it difficult, if not impossible, to pursue ambitious plans for growing Chief's business. Recognizing this fact, Southland put Chief up for sale when it announced its own LBO in July, 1987.

Over 200 companies, both U.S. and foreign, asked Southland and its investment banker, Salomon Brothers, Inc. for a copy of the offering memorandum. As mentioned previously, many of the would-be buyers were Chief's competitors, looking to acquire Chief for the areas of its operation that did not overlap their own.

Our management team felt that shrinking Chief to fit into a competitor's organization through layoffs and store closures was not a palatable option for a company with our opportunity for growth as a stand alone business. An independently owned and operated Chief Auto Parts would best serve the interests of its customers, employees, vendors and owners.

Resolved to insure Chief's continued presence in the auto parts industry, we approached Shearson Lehman Hutton Inc. about the possibility of structuring and financing a management-led buyout bid of the company. Shearson agreed to work with our team in developing an offer that met one important criteria -- it would not be financed through the sale of company asset.

Southland accepted our offer of $135 million, and in April of 1988, Chief Auto Parts Inc. became an independent, privately owned company. That behind us, we braced for the challenges ahead. Of course, the first year of Chief's LBO prompted a good number of changes in the way we did business -- but not in the ways opponents of LBOs might suspect.

The first step was a planned management streamlining and reorganization to eliminate 40 redundant positions, a move that would have happened without the LBO. Then, with our management team in place, we continued our efforts to grow the business. The results have been exciting and promising.

We have opened 16 stores, with plans to open 26 more this year. We've streamlined our purchasing and inventory operations to make them more efficient. We have been able to significantly increase same store sales almost 10 percent over the previous year, way above the average for our industry, and retail outlets in general. And we have added employees, more than 300, an increase of more than seven percent from the year before LBO.

A snapshot of Chief Auto Parts today would show a profitable, entrepreneurial and growing company. And there have been some additional, unseen benefits from the LBO as well. An initial fear was that an LBO would cast a long shadow over employee morale. Just the opposite has proven true. We have found that people are willing to work much harder -- and happily so -- when they are made to feel personally responsible for the health of an organization. A new team spirit is pervasive throughout the company, making it an exciting place to work.

And Chief is a stronger company than a year ago because we operate leaner and more efficiently. Our cash flow to debt payments ratio is such that we can continue to make uninterrupted interest and principal payments even if business falls off in an economic slowdown. This past year, we have not only paid off our interest, but have also paid down $13 million off of our principal debt of $130 million.

Although everyone in our business remains vulnerable to competition and economic and market forces, we are no more vulnerable than our non-LBOed competitors. It can even be argued that the financial discipline involved in an LBO leaves us in a better position to weather the occasional bad patch of business.

As in any business, we still have many challenges ahead of us at Chief Auto Parts. But the successes of the past year would not have been possible without the ability to borrow money to purchase the company. A leveraged buy-out is a financial tool, that when used the right way, allows companies to make better use of their resources. Looking at Chief as one case study, the results have included expansion of our business, new jobs, a more efficient company and the maintaining a competitive marketplace.

It is for this reason that I urge the committee to proceed with utmost caution in altering the status quo on leveraged buyout transactions. Thank you.

Mr. GIBBONS. Thank you, sir.

Mr. Dorgan, and then Mr. Moody, and after that, we will have Mr. Thomas.

Mr. DORGAN. Thank you, Mr. Chairman.

The testimony from all of you is very useful testimony. I think it needs to be said that there are good LBO's properly motivated that are successful in the end, and there are very likely bad ones that should never happen and turn out to be failures.

But this hearing is not just about LBO's. This hearing is about takeovers, hostile takeovers, mega-mergers, LBO's, all lumped into one giant menu.

I am mindful that one ought not to paint all of these with the same brush. But some of us observe that the geometric growth of mergers and acquisitions from $12 to $15 billion in the 1970's to almost $300 billion is startling. This raises some questions about public policy, particularly in the area of hostile takeovers that are undergirded by junk bonds.

You have testified mostly about LBO's. Do you have any concern about hostile takeovers going on in this country? In fact, I noticed in one of the testimonies that I read the reason that there was an LBO is that there was fear that you would be the target of a hostile takeover.

Does that mean that hostile takeovers are of concern to you?

Mr. Fromstein.

Mr. FROMSTEIN. Yes, of course.

I think that a hostile takeover, by its very nature, threatens a certain amount of regularity in the economy or in the society.

The problem is that when you begin to try to regulate how companies are bought and sold in the free market, there is always the possibility of washing the baby down the drain with the bath water.

In my own case, anecdotally, it wasn't junk bonds that allowed the hostile takeover to take place, but it was junk equity, which is equally bad. That is, the shareholders of the takeover company, which was one-tenth of the size of the target company, were sold a bill of goods that drew them into making further investments in equity, and then so a very small company took over a very large one.

What happened is that it really didn't work. The market regurgitated that acquisition to a great degree. The stock price came down very sharply, and all kinds of management problems arose from it.

I don't know that there is any way you can legislate a takeover and prevent these things from happening, but I think that when they stop happening, and they can be unwound, I think my point was that there ought to be legislatively a way of unwinding it, because in that process a lot of bad can be switched back.

But I don't think it is possible to regulate the takeovers in that.

Mr. DORGAN. The alternative, of course, is to just sit around and do nothing, and sometimes that is the preferable alternative. My own view is that we have had a spectacular failure of regulators in this town, and I think Congress to some extent has failed as well in a number of these areas.

But I would like to ask if you were here to hear the testimony of the first witness this morning, Mr. Bloch, the director of the National Science Foundation.

Mr. Bloch indicated that they took a snapshot in time of 33 companies that merged into 16, plus 8 LBO's, and analyzed R&D expenditures. They determined that in real terms there was a reduction of 8 percent in research and development expenditures by those companies.

He said clearly that you can't draw substantial long-term conclusions from that except that it suggests that the loading up of debt for the purpose of a takeover or an LBO in many cases will most likely harm research and development expenditures.

Does that testimony give you concern?

Are there some policy issues we ought to be addressing there?

Mr. Manor.

Mr. MANOR. I also looked through the testimony, and if I recall he said that it wasn't really clear if those numbers indicated that there was—it was also colored by, or affected by perhaps greater efficiencies and the dollars being spent on R&D.

I'm a retailer, and therefore R&D in a pure sense doesn't necessarily apply to my company, but if there is some sort of R&D in my industry, it's in new store growth.

And, again, I think it goes back to the kinds of management engaged in LBO's or hostile takeovers when the numbers are put together; if the lenders are responsible and management is responsible, the numbers have to include, by their very nature, some kinds of moneys for, in my case, store growth, or, in another company's, R&D, and if they are not included, then I think, you know, the perception of the people insofar as the success of this company, is probably off target.

Mr. DORGAN. This is an unusual town in that it is probably one of the few areas where the obvious seems surprising when it is disclosed.

It seems obvious to most of us that if enterprises are loaded up with debt for any number of reasons, it would require a bursting at some seam and the most obvious place, so it would be expenditures for research and development.

My own observation of Mr. Bloch's testimony suggests, once again, an undesirable symptom from what's been happening. Now, that—doesn't lead me to believe we—ought to have massive new legislative initiatives; I think we need to deal with this carefully and understand the problem before we propose an exact solution.

Mr. GIBBONS. Yes, sir.

OK, Mr. Moody.

Mr. MOODY. Thank you, Mr. Chairman.

Mr. Fromstein, you say you didn't have enough time to arrange a leveraged buyout in the short defense period allowed.

We have been looking for possible tax instruments to stop undesirable LBO's without penalizing desirable LBO's.

What about lengthening the time period that a defense is allowed?

For example, suppose we only allowed interest deductions after a certain time period which is longer than the current time period. If a certain amount of time has elapsed so the market can respond with competitive bids or for a defensive LBO to be arranged, then interest would be deductible the usual way.

If not, maybe interest would be less than fully deductible. Is that a reasonable proposal?

Mr. **Fromstein**. The time frame is more SEC regulation, I think, than market-driven. That is, if a company is under a hostile attack, and a tender offer has been made and filed, you have 30 days to respond to it; and the clock ticks down pretty rapidly.

Mr. **Moody**. Thirty working days?

Mr. **Fromstein**. No, 30 days on the calendar, so on the 30th day, you need to respond to it. If you don't respond to it, then it's assumed that the tender is filed, and a vote is taken.

It takes more than 30 days, as the LBO people will tell you to really put together the kind of information that's needed, particularly in a large purchase, and to get the commitments and to get all the banking, all the layers of financing that go into it.

The next time it comes around, I will be prepared with all the papers stacked up. We were caught very much unaware. I think a lot of companies do have that in process.

I don't think deductibility based on timing would help this kind of thing, but I don't think it is a bad idea, in general.

Mr. **Moody**. So, if we could see the time elongated to 60 days, for example, that would give managers a change to get——

Mr. **Fromstein**. But what would be necessary is that the SEC would have to change its process and regulations, which I certainly think they ought to do to allow a target company a greater amount of time to defend itself, and particularly if it is going to try to compete with a hostile bid from a raider or a takeover company by self-financing, or by management buyout, or whatever.

It has got to have more time to get it done, and if it did in most cases it could probably equal or better a hostile takeover bid.

Mr. **Moody**. That's a real important point. We will have to pursue that elsewhere, but thank you.

You state that the way in which goodwill is handled here versus overseas gives a tilt to foreign takeovers.

Mr. **Fromstein**. Yes.

Mr. **Moody**. That's a real important point.

Do you want to elaborate on that, sir?

Mr. **Fromstein**. Yes. It is a heavily unbalanced playing field on which U.S. companies particularly in the low fixed asset field must live. The service companies just can't compete with foreign companies.

It is the strangest kind of thing because it's an accounting differential, then compounded by the SEC that says when that accounting differential takes place, that, in fact, you've got to keep it on your books, even though in Britain, for example,——

Mr. **Moody**. It was written off.

Mr. **Fromstein** [continuing]. It was written off.

So, in our case, $1 billion worth of goodwill was written off by the British company, and yet if we were to bring back Manpower to the United States, to the capital markets, we would have to put that billion dollars back on our books. In fact, they say it never left. Write it off at a rate of—well, $40 million a year with no tax impact allowed, against after-tax earnings, which would cut our earnings in half.

Therefore, our earnings as reported in Britain would be twice as much——

Mr. MOODY. Right.

Mr. FROMSTEIN [continuing]. As they would be reported in the U.S., and each of them to the same kind of stock or security buyer. Something just is crazy about that.

Mr. MOODY. The same fundamental facts, the same company, the same everything——

Mr. FROMSTEIN. Exactly.

Mr. MOODY [continuing]. The tender offer from a Britisher, and perhaps other European firms, could be up to twice as much as the——

Mr. FROMSTEIN. Yes.

Mr. MOODY. And once it's lost it is even harder to bring it back?

Mr. FROMSTEIN. It's impossible.

Mr. MOODY. I think that's something that we really ought to look at.

Thank you.

Any other gentleman have the comments on that point?

[No response.]

Mr. MOODY. Let me ask Mr. Lee: R&D has been made much of here. The two gentlemen on your sides do not have companies engaged in a lot of R&D, I don't believe, but presumably some of your companies do.

Mr. LEE. Yes, sir.

Mr. MOODY. You have a wide mix of companies.

Can you comment on the argument that R&D would be one of the first things to be cut. Or do you take the view that R&D, like any other expense is going to be looked at in a cost-effective way—you don't cut it if it yields more than it costs.

Mr. LEE. Right, I would say that we have not cut research spending in companies which we have bought. But, on the other hand, have it that we haven't bought a lot of technology-oriented companies. They would be too susceptible to obsolescence of equipment, so that we have looked at R&D, made it somewhat more effective, but we certainly kept it.

In terms of our study, we found that capital expenditures and that engineering has really gone up, and as I say this is in Tab 2 and 3 of the study.

Mr. MOODY. As you've taken on more debt, what have you had to cut to carry that debt?

Mr. LEE. Well, we have actually grown our companies, our sales have grown to 14.5 percent compounded annual rate, as opposed to the economy in general, which is 6.5 percent.

We have increased plant and equipment. We have increased the stores saying the terms of our retailers, so that we haven't cut. We've actually spent more.

But you have to have revenue growth and also operating profits, to grow, put that strategy to work

Mr. MOODY. Thank you.

Mr. GIBBONS. All right.

Let's see, Mr. Coyne, and Mrs. Johnson.

Mrs. Johnson.

Mrs. JOHNSON. I pass.

Mr. GIBBONS. Good.

Mr. Pickle.

Mr. PICKLE. Mr. Manor, I'm interested in your operations, mainly to just get some facts from you.

You had a company that your people bought from Southland.

Mr. MANOR. That is correct.

Mr. PICKLE. And you financed that at a price of $135 million, as I understand from your testimony.

How did you finance it? How did you work the deal? You went to Shearson, Lehman—and you got the money from them?

How much did you get? How did you finance it?

Mr. MANOR. The financing arrangement was such that a total of approximately $10 million in equity was put in between Shearson, Lehman, Hutton, and a management group.

Mr. PICKLE. Well, I understood from your testimony that the offer was $135 million——

Mr. MANOR. And some assumed liabilities.

Mr. PICKLE. And then you said this past year you have not only paid off the interest but have paid down $13 million off the principal debt of $130 million—your principal debt was $130 million.

Now, did you have equity of $5 million, or $10 million?

Mr. MANOR. We had equity of $10 million, and we took on—the offer was for, it was actually about $138.

Mr. PICKLE. Well, all right, but I didn't note that. But you had equity of $10 million?

Mr. MANOR. That is correct.

Mr. PICKLE. Then you floated a bond issue of some kind, of what, $130 million?

Mr. MANOR. No, sir, the asset value of the company was in excess of the offer that we made on the company, and so General Electric Capital Corp. came in and provided the debt money, and we used the assets.

Mr. PICKLE. Well, how much debt money did they provide?

Mr. MANOR. Well, including working capital, the total debt was in the neighborhood of about $140 to $145 million, because we had working capital that we were working with at the time.

Mr. PICKLE. Where did you get the capital? Was it through a bond issue of some kind?

Mr. MANOR. No, we leveraged the assets against the loan.

Mr. PICKLE. I don't understand you yet.

Mr. MANOR. Well, there was no bond involved. I signed notes to General Electric Capital Corp., and we pledged the value of the assets to back up the loan, similar to buying a home. I put in 10 percent equity, and the value of my home would be the backing for the loan.

Mr. PICKLE. Well, what part, if any, did your investment banker play?

Mr. MANOR. I'm sorry, I didn't understand the question.

Mr. PICKLE. Your investment banker? Shearson Lehman Brothers? Did they have any part in this operation?

Mr. MANOR. They put in approximately 83 percent of the equity, or about $8.3 million.

Mr. PICKLE. But you didn't issue any bonds?

Mr. MANOR. No bonds were involved.

Mr. PICKLE. You just borrowed it from Shearson Lehman Brothers, and the other entity?

Mr. MANOR. No bonds were involved, no.

Mr. PICKLE. Well, this committee has not contended that all acquisitions are bad. Some of them can be good, and can be helpful. You didn't use any bond, you just borrowed the money, and took a note and you are paying it out. So, this kind of a leveraged buyout seems entirely different in character from the RJR-Nabisco operation.

Mr. MANOR. If I could comment to that, I understand that completely, and I am certain that the deal that I was involved with not only is very small by comparison with the issues that this committee is dealing with.

Mr. PICKLE. Yes.

Mr. MANOR. And perhaps my experience being quite limited is rather parochial in my views. However, the concern that I have is that any kind of legislation that will ostensibly minimize what appears to be the negative aspects of the RJR-Nabisco is very likely to affect what I believe it to not be a very negative deal, such as mine.

Mr. PICKLE. How could we pass legislation that would affect what you did? You wanted to buy the company; you made an offer, and you borrowed the money from different sources, but primarily from Shearson Lehman Brothers. Now, how would legislation we might consider affect that kind of operation?

Mr. MANOR. Well, I guess it would depend on the direction that the legislation would take, but I've heard a great deal about limited interest deductions. I am paying a substantial amount of interest, and until my debt is paid down, if there is some change in the amount of deductibility, my interest changes the pro formas of my organization, and it would have a negative impact on it.

Mr. PICKLE. Do you pay dividends in your corporation?

Mr. MANOR. We are incorporated. We have no profits. We had no profits last year. We will be profitable this year, but we had no dividends at this point.

Mr. PICKLE. You are a corporation?

Mr. MANOR. That is correct.

Mr. PICKLE. So, you're saying that any limitation on interest deductions would adversely affect your type of operation?

Mr. MANOR. It would have an adverse effect on my operation, yes.

Mr. PICKLE. Well, that's an interesting observation, but I think something we've got to consider as we approach this overall subject.

Mr. Fromstein, I think we do have a problem with regard to the foreign aspect, and how we treat goodwill. I recognize that is something we have to take into consideration.

Thank you, Mr. Chairman.

Mr. GIBBONS. Yes, sir.

Mr. Manor, you were essentially a subsidiary of 7-Eleven, is that right?

Mr. MANOR. That's correct. The parent company is Southland.

Mr. Gibbons. And they are pretty successful folk as I watch them in my neighborhood.

And they just decided they had rather be in the grocery business than selling auto parts, is that what happened? They did a leveraged buyout on themselves, didn't they?

Mr. Manor. That is correct.

Mr. Gibbons. And then you were going to be tossed away as—I shouldn't say "tossed away," but sold off, and so your management bought your company.

Is that what it is?

Mr. Manor. That is correct.

Mr. Gibbons. That's what happened.

And I guess that what you said, those auto parts you had in stock were just valued more by General Electric Finance and by you than they were by 7-Eleven or by the other bidders, isn't that essentially what happened?

Mr. Manor. Essentially. The value was established by outside appraisers.

Mr. Gibbons. Yes, sure. That's right.

Mr. Fromstein. I know what you mean by "junk equities." I have a few of those. [Laughter.]

That's like betting on a horse race when the odds are real high, you are just betting on the odds. I've got some of those.

Thank you very much.

Yes, sir, Mr. Coyne.

Mr. Coyne. Thank you, Mr. Chairman.

I'd like to ask Mr. Lee if Congress and the administration were able to devise a way to examine mergers on a case-by-case basis to determine their usefulness to society, would you agree to denying the deductibility of interest if it was found that the merger not be in the public interest?

And I'd like the other two panelists to comment on that.

Mr. Lee. Actually, I myself wouldn't be for it, although I think if you study Great Britain and Japan——

Mr. Coyne. I didn't hear your response. You say you wouldn't?

Mr. Lee. No. Except I believe if you look at the English system, they do have a system to see through the monopolies commission, whether a merger is good for the country.

I think it is very difficult—MITI—Ministry of Industry and Trade also looks at it in Japan. So, it is something that maybe should be studied.

I certainly favor Mr. Fromstein's suggestion that if a hostile raider comes after a company, frankly it may be a bad company; it may be a company where the management is doing a very poor job.

So, maybe that hostile raider is actually doing the shareholders and everybody a good service. But he may not be, so—but to extend the period of the offer from 30 days to, say, 60 or 90, might be a very good and salutary thing because it is a very sophisticated question that had been asked earlier, and it really revolves around who should be allowed to own American companies.

Who is a good acquirer and who's a bad acquirer?

Mr. Coyne. Mr. Fromstein.

Mr. Fromstein. Mr. Coyne, I think you have raised an essential question, that, while it won't be resolved quickly, I think really goes to the heart of a lot of the things that the committee is looking into in general.

And that is that in the United States we have a practice of handsoff in terms of government, in terms of the marketplace. It's worked very well, through the history of the country, and entrepreneurs have built businesses and done very well, and done very well in the capitalist system.

But what we are doing today is looking into a world market where you have Europe consolidating, Asia consolidating, Latin America consolidating, and those people all have protective devices built-in and on the planning board that will save their industries, that they consider to be important to the economic fabric of the society.

If the United States does not have that, no matter how wrong it seems to have government interfere, if we don't have something of that sort, then what's going to happen is that the best of our industries, service and manufacturing, are really going to suffer because we have no way of protecting against foreign acquisition of those companies.

So, however light it is, there ought to be something in terms of Government involvement.

There is one thing, that is, the President of the United States today has the right by Congress to declare something, or a business essential to the defense of the Nation, and therefore to stop a takeover by a foreign firm from taking place.

But really what's the difference between somebody who is in the defense business and somebody in a company that has 250,000 jobs, or an IBM that has 385,000 jobs, that it isn't only the defense that is important to this Nation, it's its global position economically, and you may have to do some protection against simply a foreign takeover coming in and particularly when they can do it on a cheaper basis than an American company can do it.

I think we are going to have to be facing that in the next decade.

Mr. COYNE. Thank you.

Would you care to comment?

Mr. MANOR. Yes, Mr. Coyne, I would not be in favor of limiting the interest deduction because what concerns me more than anything else is who makes the determination on what's hostile, and what's for the public good?

I mean, as my deal was structured, and we are sitting here now saying—everybody is nodding and saying yes, it looks like it was a good deal, but it could just as easily have fallen in someone else's hands who didn't think it was a such a good deal, and I could have been negatively impacted.

Regarding protectionism, I think that one of the things that we need to be is extremely cautious because those kinds of measures generally breed complacency, not always, but generally breeds complacency.

And, as Mr. Lee indicated, many of the companies that he has purchased have not cut their R&D, and the question is asked, well, what does get cut?

Well, inefficiencies get cut, and nothing makes a management team in a company more focused than debt, and debt is not necessarily good or bad; it just exists, and if a company has room to improve and they are focused, then generally they can work themselves out of a situation, if the deal is properly put together to begin with.

Mr. COYNE. Thank you.

Mr. GIBBONS. Thank you very much. Good question. Good answer.

All right, now, for the last panel. Let's see whom have here.

Well, we've got Roger—Roger Mentz. Come on up, Roger.

Mr. Stolberg. Mr. Scherer. And Mr. Michel.

Roger, we welcome you back.

Mr. MENTZ. Thank you, Mr. Chairman.

It's nice to be back.

Mr. PICKLE. Mr. Chairman, may I——

Mr. GIBBONS. Sure.

Mr. PICKLE [continuing]. Welcome Mr. Mentz again?

Mr. Mentz, we are glad to see you before this committee once more, and appreciate the considerable contribution you have made to us in previous administrations.

As I recall, we have brought this subject up again about 3 years ago, when you were with Treasury. We didn't advance it very far, and I'm going to assume, Mr. Mentz, that you are suggesting that we proceed very cautiously on this question, and that we view with alarm every recommendation.

I've got to go to another meeting now, and that's the reason I'm asking this broad question. Do you still say that we ought to be very, very careful and——

Mr. MENTZ. No. I'm going to try and give you a tax policy framework to analyze these issues with, and, frankly, I don't think it has really been articulated before, Mr. Pickle.

I'll be glad to provide it for you, and if you have to leave now, I will make it available to you separately.

Mr. PICKLE. I've got your testimony. I'm going to be looking at it.

Mr. MENTZ. All right.

Mr. PICKLE. I'm hoping that we can find some leadership somewhere to find a better way to do things than we are now; but I'll read your testimony.

I'm sorry I have to leave now.

Mr. MENTZ. I do have a serious problem. If you adopt a "50-50" approach a little off of interest and a little on to equity, I think that's the wrong way to go.

Mr. PICKLE. Is it the figure, 50-50?

Mr. MENTZ. No.

Mr. PICKLE. Or any kind of a balance?

Mr. MENTZ. No, I think that you are looking at—if you look at all debt as monolithic, you are not really grappling with the tax policy issue.

You see, the way I look at it, interest on debt that is bona fide and that is incurred to finance a business, is deductible. It's an expense just like a salary. Where you've got to look is where the debt takes on a little bit of the flavor of equity, and the division is not easy.

But if you have a company that's got 20 percent debt, and 80 percent equity, I think it would be terribly unfair to knock off 50 percent or some other figure of its interest deduction.

Mr. PICKLE. Mr. Chairman, I'm preempting Mr. Mentz' testimony, and I don't intend to do that, but I think during the hearing somebody ought to ask him if you think that these leveraged buyouts would be in existence if we didn't have the right to deduct huge amounts of interest associated with junk bonds and other debt?

Mr. MENTZ. I believe they would. I think you would still have leveraged buyouts, and Joe Rice, who is the president of Clayton & Dubilier, can speak to that. But I think the price would be different.

But I do not agree with Treasury's position that all you have to do is balance it out and they would go away. I think they are here as long as they——

Mr. PICKLE. Well, I don't know that that's Treasury's position. If it is, that's encouraging. I didn't know they took that position.

Give me the source of that recommendation. I want to trace that one down.

Mr. GIBBONS. Let's go to Congressman Stallings. He's been sitting here patiently and quietly.

We appreciate your coming to our hearings today, Mr. Stallings, and you may proceed and introduce your constituents.

STATEMENT OF HON. RICHARD H. STALLINGS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IDAHO

Mr. STALLINGS. Well, thank you, Mr. Chairman.

I am pleased to have this opportunity to introduce Mr. Ted Stolberg, managing partner of the investment firm of Weiss, Peck & Greer, and head of their turnaround buyout group.

We use the term "turnaround" because it references a unique philosophy of buyout activity currently practiced by only a few investment groups.

In a nutshell they believe that most troubled companies can be fixed with a combination of pro-active steps that fix simple fundamentals that have usually been ignored by much of Wall Street.

They have an excellent track record of putting people back to work, and, Mr. Chairman, this is one of the reasons that I am here today. They have taken a company in my district that was in bankruptcy, that had laid off all but a few essential workers and turned that company around. They have 400 people working, and it is a very successful fertilizing manufacturing operation.

Today, the company is profitable and competitive, and I believe understanding of their experience would benefit all of us.

So, I am pleased to accompany my friend today, and look forward to his sharing his testimony with you.

STATEMENT OF E. THEODORE STOLBERG, PARTNER, WEISS, PECK & GREER, NEW YORK, NY

Mr. STOLBERG. Good afternoon.

Let me begin by saying that I've got some problems with the perception that all buyouts are like RJR-Nabisco. In fact, many of the buyouts in this country are smaller, and they are below $100 million in purchase price.

Often these companies are kind of beat up and abused and stepchildren of larger companies. Most buyouts in this country don't rely on junk bonds and bridge loans or bust-up strategies. They are not about hostile tender offers, but rather really negotiated purchases between buyer and a seller.

Most buyouts are not one-night stands with companies where you take the money and run. They are really about long-term investing to build real, sustainable business enterprises. Most buyouts aren't about fancy Wall Street engineering, or complex tax games, but really about serious, mature, operating executives dedicated to running their businesses competitively.

The heroes in the story are really the operating executives. They live on Main Street. They run plants in Paducah, KY; Marion, IN, and Cortland, NY; and they've got an interesting emotional, and financial stake in the businesses that they run.

They are like many small proprietorships in this country—and it is the proprietorships that have been responsible for generating most of the new jobs in this country.

These managers want to do the right thing, they want to do the right thing for their companies, their employees, the communities in which they work, us, their investors, themselves, and also their families.

Let me give you an example of what we call a turnaround buyout, and I think the turnaround buyout is a trend that will serve this country well in the future.

In 1984, Harry Schell was a 50-year-old operating executive responsible for a small, unprofitable business that was owned by Phelps-Dodge. Phelps-Dodge was selling it. Harry Schell and his team had a dream of buying the business. They put personal money on the line. We put money on the line, and we arranged the rest from banks.

The management team greatly reduced costs, improved the quality of their product, expanded the product line, purchased and fixed two beat up U.S. competitors that were losing money and going out of business.

Today, Harry Schell's company is the most competitive high-voltage electric power cable business in America. Sales went from $40 million to $200 million—to $250 million, excuse me.

Operating profits, he was losing $2 million; he's now making $30 million in operating profits.

Capital expenditures expanded by 13 times, and he saved 500 jobs.

I believe that the old formula buyout business, that is buying good business, good management, good cash-flow is dying. I think the party is over. Back in 1981, when we founded our buyout group, good recession-resisting companies with stable cashflows and in-place experienced management teams, were dirt cheap.

The next 7 years did nothing but make those investments better. Interest rates were cut in half; the economies had the longest recovery since World War II, and the returns in the LBO business were astronomical, 65 percent per year, on average.

It's no wonder that gobs of money came into the business. Today, we have got $300 billion driving up the prices of many of these kinds of old formula buyouts to the point where they don't make sense; and the economic recovery of the past may not be there to bail out overpriced deals.

Having said that, in the face of all these events, commercial banks, insurance companies, pension funds and LBO sponsors have all become much more selective recently.

We at Weiss, Peck & Greer recognized 3 or 4 years ago that the new emerging trend was the turnaround buyout, which is fundamentally fixing the factory floor and how your products get to market.

Let me give you one other example that Congressman Stallings alluded to: Nu-West Industries started out as a shutdown, mothballed fertilizer plant in Conda, ID. We joined forces with three experienced fertilizer executives, bought the facility out of bankruptcy court. This management team restarted it, hired 400 people.

Today, this company is publicly-held, $200 million in revenues, makes about $15 million in operating profits. Total employment, 1,000 people, up from zero.

Let me summarize by saying that I believe the 1990's will be the age of the operating manager. Wall Street alone cannot fix the factory floor; and, with all due respect, Congress can't do it either.

We hope that these deliberations will lead to a greater understanding and support for this unusual group of operating managers whose mission is to fix fundamental factory floor problems; it's a win-win deal; jobs get saved; new jobs get created; businesses become more healthy and more competitive, and I might add more able to pay taxes.

A company wins; we as investors win; customers win; suppliers win; and employees as well.

Thank you.

[The statement of Mr. Stolberg follows:]

Testimony by

E. Theodore Stolberg

Partner of Weiss, Peck & Greer

Mr. Chairman and Members of the Committee:

My name is Ted Stolberg. I'm a partner with the New York-based private investment firm of Weiss, Peck & Greer. It's a pleasure to be here today to give you a small LBO practitioner's views.

Let me begin by telling you that not all leveraged buyouts are like RJR Nabisco. The middle-market deals in which Weiss, Peck & Greer is involved don't make the headlines often, but do account for a much greater share of the entire LBO market than the "mega-deals" which get all the press. Middle-market buyouts typically involve companies which have purchase prices of between $5-$100 million; the companies may or may not be profitable. This segment of the market is comprised of numerous small buyout practitioners similar to Weiss, Peck & Greer, who join forces with operating management. Target acquisitions for these small to medium sized deals are usually those minor, ignored divisions of public corporations which have been earmarked for divestiture. Or, they may be family-held private companies with an owner who desires liquidity.

While the "mega-deals" which have huge price tags account for more than half of the dollars spent on LBOs, the statistics show that more than 50% of buyouts in 1988 were middle-market deals (see chart below). Viewed as a pyramid, the large deals are at the pinnacle of the pyramid and receive the lion's share of both positive as well as negative publicity. But focusing on only the mega-deals and assuming that they represent the true nature of the leveraged buyout business is like looking at the fifty largest companies in America and assuming that they present a fair picture of what goes on in small local businesses and sole proprietorships all across the country.

Leveraged Buyouts in 1988 by Transaction Size
(Dollars in millions)

Transaction Size	Number of Buyouts	Percent of Total	Dollar Volume	Percent of $ Total
Under $50 million	105	34.5%	$ 2,206.6	2.2%
$50 - 99.9 million	58	19.1%	4,086.8	4.2%
$100-499.9 million	105	34.5%	22,334.0	22.7%
$500-999.9 million	19	6.3%	13,961.0	14.2%
Over $1 billion	17	5.6%	55,687.0	56.7%
TOTALS	304	100.0%	$98,275.4	100.0%

Source: "Buyouts", published by Venture Economics - January 11, 1989

The most salient point of a recently-completed study of the leveraged buyout marketplace by Venture Economics "is the predominance of smaller deals in an industry that the public and the popular media have mistakenly come to associate with huge transactions. These smaller LBOs — in particular, those below $100 million — might more accurately be described as management buyouts, since their success depends on management skills far more than on asset sales or financial engineering."

Participants in this vast middle market generally don't rely on junk bonds or bridge loans or quick asset sell-offs to make their deals work— and they aren't fancy Wall Street financial engineers. Nor do they do hostile transactions. But they are long-term investors who are interested in building significant companies, rather than short-term speculators who want to make a quick buck. Although it may sound like motherhood and apple pie, these LBO's are successful because they are based upon the principle of making money the old-fashioned way: through hard work on fundamental business issues performed by an experienced, motivated team of operating managers.

By team, I don't just mean the few senior managers at the top. Weiss, Peck & Greer invests not only in a company or in assets, but more importantly, in people. It is critical that experienced and mature operating management teams have both "emotional" and significant financial equity in the business. Our operating managers aren't in it just for the money — they get their satisfaction through building a solid, successful company from the ground up. If the deal is a success, everyone participates and everyone wins — including the employees on the factory floor.

So what kind of managers are these CEO's? Well, they don't look, talk or act like Ross Johnson from RJR Nabisco. None of our private company CEOs had a need for a "golden parachute"; some of them didn't even know what the term meant. Weiss, Peck & Greer looks for fifty-year-old managers who have always had a desire to own and run their own business and who desperately want to take control of their own destinies. These people don't know much about Wall Street. They live on Main Street, USA; we've found them in places such as Paducah, Kentucky; Pascagoula, Mississippi; Marion, Indiana; Yonkers, New York; Conda, Idaho; and York, Pennsylvania.

Let me give you some real-life examples of this kind of manager. Harry Schell of Cablec Corporation worked his whole life under the bureaucracy of a public corporation. He always knew he could run this division better on his own. In 1984, his dream became a reality. He put his own money at risk side-by-side with Weiss, Peck & Greer's, and in five years, he's tripled the size of his company. Fred Collins of Microwave Radio doesn't have a college degree, much less an M.B.A. But he had an unshakable belief in his abilities and in the market for his division's products. He was turned down by thirty-five different investment firms, and ended up buying the original furniture for his company with his own personal credit card. Two years later, Microwave Radio has doubled in size and entered new markets due to Fred Collins' entrepreneurial vision. The CEO of TransLogic Corporation, John Mahoney, took out a second mortgage on his home because he wanted so badly to run his own company, and he knew he could do it. Since then, TransLogic has made three strategic acquisitions and revenues and employment have doubled.

Evidence shows that our strategy of making a long-term investment in acquired companies and, with seasoned operating managers in place, growing them rather than selling off assets has succeeded. Instead of "slashing and burning" after a buyout is completed by cutting expenses and laying employees off, we are guilty of the opposite: making significant long-term investments in companies in fundamental industries. Revenues, employment, productivity (as measured by sales per employee), capital expenditures and research and development have all increased in these companies. Specifically, aggregate revenues for six middle-market buyouts completed in the last six years increased from a total of approximately $489 million to over $761 million. More importantly, the number of employees at these six companies effectively doubled, from 1664 to 3298. These management buyouts actually created over 1600 jobs. Capital expenditures also doubled from $6.3 million to over $13.4 million. These figures reinforce our fundamental belief in the value and benefits of middle-market LBOs.

But times are changing. When Weiss, Peck & Greer's management buyout group was formed in 1981, bargains abounded. A good business in a basic, recession-resistant industry which had an experienced management team and consistent cash flow could usually be purchased below book value. Typically, buyers paid between three to five times operating earnings with a price/earnings ratio of perhaps 13 or 14 for such businesses. This formula worked so well for the last few years because the environment was working in everyone's favor: price to earnings ratios increased, interest rates fell and the economy was in an upswing.

Naturally, this favorable environment attracted competition. Today, LBO funds hold an estimated $30 billion in capital. Applying a leverage ratio of 10 to 1 implies that $300 billion is available for these "old-formula" buyouts. As a result of these vast pools of capital, demand for companies has soared. Pricing has jumped up to levels of twice book value and 8 to 14 times operating earnings. Price/earnings ratios often reach 24 times today for the traditional leveraged buyout candidate.

But, these "old-formula" LBOs are a dying breed. In fact, I'm here to say that the party's over — no longer will financial engineering skills alone guarantee successful deals. We are in an uncertain economic environment with a recession not too far off. Many astute observers suggest that American business is overleveraged and are seriously concerned with the erosion of this country's capital base. We at Weiss, Peck & Greer are as concerned as you are. I'm certain that many witnesses at Congressional hearings will assure you that their industries are self-policing and there's no need for Congress to take action. However, I'd like to give you some specific, tangible examples of how the LBO market really is responding on its own to this changing environment.

Banks have already begun to tighten their credit rules and investment criteria for LBO deals. Increasingly, they are focusing on lending only to experienced LBO practitioners who have a strong track record of successful deals. Banks are insisting that dealmakers do more due diligence than ever before, and are challenging the assumptions and viability of management's projections in anticipation of a serious recession in the next 18-24 months. For their part, Federal Reserve Board bank examiners are seriously pressing banks regarding the highly-leveraged companies in their loan portfolios. Limited partners in buyout funds, accustomed to the "easy pickings" of traditional buyouts in the last ten years, are increasingly concerned about the types of investments which their general partners are making and have become far more conservative with regard to investing in these partnerships. In short, each of the diverse constituencies involved with the leveraged buyout business has already begun to put mechanisms in place to ensure the continued survival and health of the business. Candidly, there is too much money at stake for the industry not to regulate itself going forward.

In the mid-1980's, Weiss, Peck & Greer recognized that the economic environment was changing and was becoming less accommodating for traditional leveraged buyouts. Accordingly, we have placed an increasing emphasis on turnaround and restructuring investments where opportunities exist to acquire underperforming businesses and return them to profitability. Typically, these are businesses with strong intrinsic value but whose operating results are hampered by poor, unimaginative, or overly bureaucratic leadership. Often, they are the "poor stepchildren" of corporate America — business units which no longer represent a "strategic fit" with the parent company but which are diamonds in the rough to their operating managers. As a result, the Weiss, Peck & Greer/new management partnership can add significant value and revitalize the underlying assets of the business through leadership coupled with financial and operational restructuring. We have included several examples of Weiss, Peck & Greer turnaround buyouts below:

Cablec Corporation - New City, New York

In 1984, Cablec Corporation was a small, unprofitable division which manufactured high-voltage power cables. WPG formed a partnership with existing management, led by the general manager. As part of the acquisition, the team dramatically reduced costs and more efficiently managed their assets, and refocused the business to exploit the company's strong product reputation. Cablec next led a consolidation of the industry by acquiring several American competitors who were losing money, and obtaining the rights to complementary technologies, thereby expanding its product line. Today, Cablec is the leading North American manufacturer and distributor of high-voltage power cable. Revenues have more than quadrupled, capital expenditures have increased thirteen times, and, most significantly, employment has tripled.

AIMCOR - Deerfield, Illinois

AIMCOR was formed in 1985 when WPG joined forces with an experienced team of turnaround executives. Previously the Industrial Products Group of International Minerals & Chemical Corporation, the division did not represent a strategic fit with corporate objectives and had experienced a sizeable loss in the year prior to its acquisition by WPG. In its first year of independent operation, AIMCOR repaid all of its acquisition debt through improved working capital management, divestiture of non-strategic assets, and restructuring existing operations and facilities. Importantly, management created a strongly entrepreneurial environment which revitalized the company. Today, AIMCOR is a profitable, worldwide supplier of petroleum coke products, ferroalloys and various industrial minerals.

Nu-West Industries, Inc. - Denver, Colorado

Nu-West Industries is now a profitable, publicly-traded company with over $200 million in annualized revenues. In mid-1987, WPG partnered with two highly-experienced fertilizer industry veterans to acquire a mothballed phosphate fertilizer plant and a 50 percent interest in an affiliated mine from the Chapter 11 bankruptcy of Beker Industries. The plant was restarted, 400 workers were rehired, and a salesforce was re-established, all of which allowed Nu-West to enter the marketplace with minimal disruption. In mid-1988, Nu-West acquired two other mothballed facilities which management is currently reconfiguring. In December 1988, Nu-West became a publicly-traded company. Total employment at June 30, 1989 is projected to be close to 1,000, up from virtually zero.

Conclusions

In your deliberations over the tax policy issues associated with leveraged buyouts, I'm asking you to consider the great differences between the various types of management buyouts which we have discussed above. They're not all RJR Nabisco mega-deals in which management is apparently focused primarily on lining its own pockets at the expense of employees and shareholders. In particular, please recognize that some LBOs, particularly those in the middle market, do add significant value to our economy. Specifically, they add jobs to communities which sorely need them and which (in some cases) would otherwise have become ghost towns.

We believe that the LBO marketplace is effectively policing itself and has already put in place mechanisms to safeguard against a "financial meltdown". LBO practitioners are being forced to keep pace with — and to anticipate the changes to come — in the market in order to continue to make investments which make sense for all concerned.

The 1990's will at last see the dawn of "the age of the operating manager". The unsung heroes — people like Charlie Gallagher, Harry Schell and Mack Barber who run plants in places like Pascagoula, Mississippi and Conda, Idaho — will have their day. These are people who are willing and able to take over the immense task of turning around failing American businesses and, above all, who take pride in their work and rise to the occasion — all for the chance to control their own destinies and run their own companies.

Who else can or is willing to do this work? The Ross Johnsons of the world can't handle it. Wall Street alone can't handle it. And, with all due respect, I don't think Congress could do it. These buyouts are not about Wall Street, or financial engineering, or greed, or creating paper profits. They're about regular guys with regular jobs who finally get the chance to prove what they knew all along — that they could do it.

And what role does the small LBO practitioner play in all this? Of course, we provide the financial resources and equity capital. But everyone's dollars are green, and deal structuring skills have become a commodity in the buyout marketplace. We have been involved in starting, growing, and turning around small and medium-sized companies for twenty years, and bring the full benefit of this commitment and experience to bear on every one of our portfolio companies. Firms such as ours focus intensively on each company, actively working with management in all aspects of the business in order to build a strong, significant company of which we can all be proud. We have been in this specific business for a long time and intend to remain in the business of starting and building small companies for a long time to come, regardless of whether the term "leveraged buyout" remains the currently fashionable label for such activities.

Please, don't punish those who buy trouble. Trouble lies in companies where people's jobs are in jeopardy and in communities that are on the brink of economic depression. Rather, reward those who take it upon themselves to revitalize American industry and who will help to return this country to a position of global competitiveness.

Mr. **Gibbons**. Mr. Stolberg, you underestimate us as managers. We have all kinds of accounting systems, and nobody to enforce them. [Laughter.]

And if we can't fix them, like the savings and loans, we just borrow the money. [Laughter.]

Mr. **Stolberg**. I'm afraid we can't do that in the private sector.

Mr. **Gibbons**. Let somebody else pay for it; that's our motto.

OK, well, Mr. Mentz.

STATEMENT OF J. ROGER MENTZ, COUNSEL, CLAYTON & DUBILIER, INC., NEW YORK, NY, ACCOMPANIED BY JOSEPH L. RICE III, PRESIDENT

Mr. **Mentz**. Thank you, Mr. Chairman.

It's nice to be back at Ways and Means.

Mr. **Gibbons**. Mr. Mentz, we appreciate that.

Mr. **Mentz**. It is my pleasure to appear here on behalf of Clayton & Dubilier. Accompanying me is Joe Rice, the president of Clayton & Dubilier.

Mr. **Gibbons**. Well, we appreciate your working for them, but you did a fine job working for us, and we would like to have you back.

Mr. **Mentz**. Well, I don't know if there are any offers out there.

Mr. **Gibbons**. Well, not the prices we pay.

Mr. **Mentz**. That's true.

Clayton & Dubilier was formed in 1978, and since that time it has acquired 15 companies with sales of approximately $7 billion, and with an aggregate purchase price of about $4.3 billion, all of them friendly transactions.

Mr. Rice will be pleased to answer questions about any of these transactions.

Clayton & Dubilier companies have achieved an outstanding record of success over the past decade, which, of course, includes favorable and unfavorable economic climate. These companies have experienced a net increase in employment. Employee productivity has increased dramatically. Pension benefits, R&D, and capital spending are all basically unaffected by an LBO. When a company is healthy and profitable, employees have greater job security and the opportunity for increased income.

Full information on all Clayton & Dubilier transactions has been made available to Joint Tax. It is also available to any of you and your staff. Exhibit A provides a summary of these transactions.

While Clayton & Dubilier's performance is outstanding, the method of capitalizing its acquired companies is relatively standard. Equity in an acquired company is usually between 10 and 20 percent of total capital. The remainder includes senior bank debt of 40 to 50 percent, with an intermediate level of subordinated debentures for the balance.

These structures are dictated by the market. There are practical limitations on the issuance of debt to third parties to finance a business. It is difficult to be any further leveraged than these transactions are. The reason is that in the event of default, a lender usually requires rights to accelerate the maturity of the principal, and potentially force the borrower into bankruptcy.

In other words, the borrower who agrees to indebtedness to lenders is risking his business, if he defaults. By contrast, the issuance of equity does not involve those risks.

In summary, debt and equity are not interchangeable. There are significant economic differences between the most junior subordinated debt and the most senior-preferred stock.

Moving to tax policy, the United States, like virtually every other industrialized country in the world, seeks to tax net income of a business after deduction of ordinary expenses. Generally, all such countries allow a deduction for interest incurred on borrowed funds, used to finance a trade or business. We didn't propose tampering with that in 1986. Unless we are now prepared to depart from this virtually worldwide approach of taxing net income and move to a cash-flow tax or a value-added tax in lieu of an income tax on business profits, interest on bona fide debt must continue to be deductible as a cost of doing business. In other words, there is no policy rationale for disallowing some arbitrary amount or percentage of interest on debt incurred in a business, just as there would be no policy rationale for disallowing some arbitrary amount or percentage of ordinary and necessary business expenses, such as salaries.

Thus, the relevant tax policy issue is how should the law distinguish between debt and equity?

The most instructive source of authority on that issue is 40 years of case law. We have provided as an exhibit a memorandum that goes into that case law and applies it to a particular set of debentures and notes issued in one of our transactions.

Let me just quickly give you five policy concerns that you need to keep in mind in dealing with any legislative proposal involving the deductibility of interest on business indebtedness.

No. 1, competitiveness with foreign firms. It has been alluded to here today. Let me focus the point sharply. Any legislative disallowance of interest deductions could produce a competitive advantage for foreign businesses that can borrow in a foreign jurisdiction, get a tax deduction there, and use the proceeds to finance U.S. acquisitions.

Let me point out that we already have that situation under current law. We tightened our interest allocation rules very dramatically in 1986 so that a U.S. multinational cannot borrow to finance an acquisition, United States or foreign, and get an interest deduction if it is in an excess foreign tax credit limitation position.

That is not true of virtually all foreign companies. So, already today, we have a bias against U.S. companies.

We have analyzed the tax laws of the United Kingdom, Germany, France, Japan, and Canada, in the exhibit, and that analysis shows that in every one of those countries a foreign company could arrange financing, get interest deductions, and use the proceeds to capitalize a United States company that would make a United States acquisition.

An excise tax on that foreign borrowing, which has been suggested as a remedy for this competitiveness problem, would, in my judgment be a cumbersome and unsatisfactory response. Moreover, it would clearly violate U.S. treaty obligations. We would be right back in the problem of unitary tax that we have experienced over the last 10 years.

Let me just tick off the other points. My time has expired.

Financial institutions—you must be concerned about financial intermediaries that borrow and lend on a very large scale. Any arbitrary disallowance of 20 percent or even 2 percent of interest could destroy a bank. You would have to carve out an exception for them. How you do that is going to be very arbitrary.

Cost of capital—you must analyze the quantitative cost of capital effects of any proposal. This is a difficult operation; it takes very highly skilled economists.

Revenue effects—we don't know what the revenue effects are. Treasury Secretary Brady says basically he doesn't see any revenue lost, at least in the short to medium term. We have an economist from Harvard, Professon Jensen, saying LBO's produce, on balance, net positive reserve. We don't have Joint Tax numbers yet.

Revenue concerns have got to be borne in mind, but any legislative proposal that addresses a long-term concern has to balance itself against the possible short- and medium-term loss, particularly if the proposal disrupts markets.

That is something you have got to have very much in mind.

The final point, transition rules. They are always tricky. They are especially difficult in this area where we have financed our businesses with debt in the United States since before the income tax; and how you deal with those five issues, in my judgment is what you ought to be focusing on with respect to any proposal that comes before the Ways and Means Committee.

Thank you, Mr. Chairman.

[The statement of Mr. Mentz follows:]

TESTIMONY OF J. ROGER MENTZ AND JOSEPH L. RICE III
ON BEHALF OF CLAYTON & DUBILIER, INC.

BEFORE THE COMMITTEE ON WAYS AND MEANS
OF THE U.S. HOUSE OF REPRESENTATIVES

MARCH 14, 1989

Mr. Chairman and Members of the Committee. It is a pleasure to be here on behalf of Clayton & Dubilier, Inc., one of the oldest and most highly respected firms in the management buyout field. Accompanying me is Joseph L. Rice III, the President of Clayton & Dubilier. Since its formation in 1978 Clayton & Dubilier has initiated the acquisition of 15 companies with aggregate annual sales of approximately $7 billion at an aggregate purchase price of over $4.3 billion. All of the companies were acquired on a "friendly" basis, with the intention of adding value from improved operations rather than from selling off the pieces of the business. All are better businesses today than before their affiliation with Clayton & Dubilier. If Members of the Committee wish, Mr. Rice would be pleased to answer questions about the transactions undertaken by Clayton & Dubilier.

The vast majority of acquisitions made by Clayton & Dubilier have been divisions or subsidiaries of larger firms which often received inadequate attention from their parent companies. A number of Clayton & Dubilier companies export a significant percentage of their production, and many compete against non-U.S. firms in domestic and foreign markets. Clayton & Dubilier has achieved an outstanding record of success over the past decade, which, of course, includes both favorable and unfavorable economic climates. Debt obligations incurred in the financing of its acquisitions have been reduced even during the recessionary period of 1981-83 when interest rates set historic highs. Rather than increase emphasis on short term results, the transactions undertaken by Clayton & Dubilier remove the pressure on quarter-to-quarter financial performance and permit managers, who are now also equity owners, to take a longer term view. In short, managers think like entrepreneurs and are encouraged to do so. Companies acquired by Clayton & Dubilier have experienced a net increase in employment, not a decrease. In addition, employee productivity -- measured in terms of either sales per employee or operating profits per employee -- has increased dramatically, providing an excellent indication of the reinvigoration of companies after their acquisition.

When a company is healthy and profitable, employees have greater job security and the opportunity for increased income. In its most recent acquisitions, Clayton & Dubilier has given all employees a direct stake in the company through the issuance of stock appreciation rights.

Clayton & Dubilier companies have not slashed spending for new equipment or research and development. Spending in these areas has been fully maintained and, through refocusing of the efforts, has become more productive. In short, Clayton & Dubilier is an example of an American success story -- productivity, employment and competitiveness have been greatly enhanced in companies acquired by Clayton & Dubilier. We believe that Clayton & Dubilier represents capitalism at its creative best.

Full information on all of Clayton & Dubilier's transactions has been made available to the Joint Committee on Taxation and is available for any Member of this Committee. Exhibit A provides a summary of relevant statistical information.

While the performance of Clayton & Dubilier acquisitions is certainly remarkable, the method of capitalizing its acquired companies is relatively standard. Equity in an acquired company is generally between 10% and 20% of total capitalization. The remainder of the capitalization includes senior bank debt of approximately 40% to 50% and an intermediate level of subordinated debentures for the balance. The debentures may be privately placed or held by the public. Clayton & Dubilier has never used an ESOP in financing or selling its companies, nor has it ever terminated a pension plan or other employee benefit plan in order to obtain assets to finance an acquisition.

The transactions consummated by Clayton & Dubilier are driven by fundamental economics. Tax consequences are, of course, relevant to overall economics, but no Clayton & Dubilier transaction was driven by taxes as a primary consideration. Because we believe that transactions consummated by Clayton & Dubilier have a positive effect on the U.S. economy, and particularly on the economies of the regions in which the acquired companies operate, we are concerned about legislative proposals that would affect future transactions. We are also concerned about the rhetoric that seems to be damning all corporate transactions because of several highly visible transactions that have become politically unpopular. One purpose of our testimony today is to direct the Committee's attention to the nature of Clayton & Dubilier management buyouts as an illustration of how such transactions can produce beneficial results.

A second purpose of our testimony today is to provide you with our views on the issue of interest deductibility, both in the context of buyout transactions and more generally as a matter of tax policy. Since there appears to be no one particular proposal on which the Committee is focusing, we will endeavor to provide an analytical framework to address the issues involved. Then we would be pleased to answer questions as to how any particular proposal might be analyzed under this framework.

LIMITATIONS ON THE ISSUANCE OF DEBT TO FINANCE A BUSINESS

There are practical limitations on the issuance of debt to third parties to finance a business. A third party lender, whether it be a financial institution or the public through a borrowing sold through underwriters, has certain economic requirements. The lender will generally demand a fixed schedule for repayment of principal, and a fixed rate of interest (which may be floating pursuant to a formula). In the event of default of a principal or interest payment, the lender will usually require rights to accelerate the maturity of all principal payments, realize on any security, and potentially force the borrower into bankruptcy. The elements of these contractual rights are of course the subject of careful bargaining in every business transaction, but it is generally true that the borrower who agrees to issue indebtedness to lenders is risking the possible loss of his business if he defaults on his contractual obligations.

By contrast, the issuance of equity, including preferred stock, does not involve those risks. The failure to pay a dividend on preferred stock cannot result in a default that would place the business in bankruptcy. Rather, the most severe remedy is normally the election of one or two members to the board of directors, rarely a majority. In other words, the risk of bankruptcy or insolvency proceedings does not exist if payment of a dividend on an equity security is missed.

Moreover, there are economic limitations on the ability of borrowers to finance a business with indebtedness. Third party lenders do not enter into lending transactions in which they expect not to be repaid. Even so called "junk" bonds are not issued unless the lenders (or the underwriters, in the case of public debt) believe there is adequate coverage so that interest and principal payments will be made. Indeed, the senior bank debt that is commonly used in buyout transactions is generally very secure since it has priority over the business's equity, subordinated debt, and trade debt.

In summary, debt and equity are not interchangeable. There are significant economic differences between the most junior subordinated debt and the most senior preferred stock.

CURRENT CASE LAW DISTINCTIONS BETWEEN DEBT AND EQUITY

The United States, like virtually every other industrialized country in the world, has a tax system which seeks to tax the net income of a business after deduction of ordinary business expenses. Generally all such countries, including the United States, allow a deduction for interest incurred on borrowed funds used to finance a trade or business.[1] Thus, regardless of whether a business is being operated as a corporation, a partnership, or as a sole proprietorship, interest (and original issue discount) with respect to indebtedness incurred to finance the trade or business is deductible as a cost of doing business. (The significant limitations on the U.S. deductibility of interest for businesses with foreign operations are addressed in the next section.)

Unless the United States is prepared to depart from this virtually worldwide approach to taxation of net income, and to enact some form of cash flow tax or value added tax in lieu of an income tax on business profits, interest on bona fide indebtedness must continue to be deductible as a cost of doing business. In other words, as long as we retain a tax system that seeks to tax net income, there is no policy rationale for disallowing some arbitrary amount or percentage of interest on debt incurred in a business, just as there is no policy rationale for disallowing some amount or percentage of ordinary and necessary business expenses otherwise deductible under section 162.

Given this conclusion, the relevant policy issue is how the tax law should distinguish between indebtedness, the interest on which is deductible, and corporate equity, for which a deduction is not allowed with respect to dividends paid, at least in the classical two-tier tax system.[2]

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[1] Under generally accepted Schang-Haig-Simmons definitions, interest paid on indebtedness to finance a trade or business must be deducted to arrive at economic income. Goode, "The Economic Definition of Income," Comprehensive Income Taxation, pp. 22-23. (The Brookings Institution: J. Pechman ed. 1977).

The most instructive source of authority on the distinction between debt and equity is the case law which has developed over more than 40 years. Over the years, the courts have been required to consider a wide variety of individual cases which test the limits of the concept of indebtedness under our tax laws. Attached as Exhibit B is a description of that case law and an application of the case law to a fairly representative debt issue by Uniroyal Goodrich Tire Company. This application of current law to a specific fact pattern illustrates how the law operates.

As you are aware, both legislative and regulatory efforts have been made in the past to distinguish between debt and equity. Exhibit C describes these efforts. None has been successful. Thus, a bright line rule distinguishing between debt and equity currently does not exist. In our view, this is a beneficial state of the law from a tax policy viewpoint, since a bright line rule will always permit aggressive taxpayers to come right to the very edge of the law. Indeed, this was the problem that resulted in the withdrawal of the Treasury regulations previously promulgated under section 385.

CONCERNS THAT WOULD APPLY TO ANY LEGISLATIVE PROPOSAL DISALLOWING INTEREST DEDUCTIONS

1. Competitiveness with foreign firms. The ability of United States business to compete with foreign firms should be an important concern of U.S. tax policy. Any legislative disallowance of interest deductions with respect to an acquisition of United States businesses could well produce a distinct competitive advantage for foreign businesses that can borrow in a foreign jurisdiction, obtain an interest deduction in that jurisdiction, and use the proceeds of the borrowing to finance the U.S. acquisition. In this connection, your attention is specifically directed to the following:

- Under current law there is already a competitive advantage for foreign corporations over United States multinational corporations which incur debt to consummate an acquisition, whether in the United States or abroad. This is because borrowing by U.S. businesses with foreign activities will often result in the effective disallowance of interest deductions that are allocated to foreign source income and thereby reduce the taxpayer's foreign tax credit limitation. The interest allocation rules were significantly tightened by the Tax Reform Act of 1986. Our interest allocation rules are much more restrictive than those of other industrialized countries.[3]

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[2] As you know, some countries have integrated the corporate-shareholder tax system to avoid or mitigate the double taxation of earnings distributed as dividends. While this may be a desirable goal, you should note that in no other country where the corporate and shareholder taxation systems are integrated was the integration achieved through a reduction of the deduction for interest. There is no rational link between providing a measure of double taxation relief for equity and disallowing some clearly business-related deductions for interest, or, for that matter, other trade or business expenses.

[3] See The Competitive Burden: Tax Treatment of U.S. Multinationals, The Tax Foundation (1988).

- An analysis of the tax laws of Germany, Japan, France, the U.K. and Canada indicates that a foreign corporation doing business in one of those countries could in fact incur indebtedness to finance a U.S. acquisition and obtain a tax deduction for interest in the foreign jurisdiction, subject to certain conditions in some countries. See Exhibit D. This analysis, which includes the effect of interest allocation rules in the foreign jurisdictions, indicates that concerns expressed about allowing an advantage to foreign-based firms through a change in U.S. law regarding interest deductibility have a legitimate basis. Any proposal to change United States law should take into consideration the implications in at least these foreign jurisdictions.

- An excise tax on borrowings incurred in a foreign jurisdiction would be a cumbersome and unsatisfactory response to this concern. Any such proposal would either be ineffective or unfair, and in any case would violate U.S. treaty obligations.

2. Financial institutions. Any broadly constructed interest disallowance proposal would be severely unfair to financial institutions. In the case of a financial intermediary which borrows and lends large amounts and is typically highly leveraged (such as a bank), any disallowance of interest expense would produce tax liability far in excess of net income, and in some cases in excess of net worth. If broadly constructed legislation is proposed, some exception for financial institutions would be necessary. In such case, the definition of a financial institution would be extraordinarily difficult, and at the margin a "cliff" effect would be created, depending upon whether a taxpayer did or did not qualify for relief as a financial institution.

3. Cost of capital. Any disallowance of interest deductions would have to be analyzed from the standpoint of its impact on the cost of capital to United States business. At present, the cost of capital in the United States is significantly higher than in Japan and other developed countries. The subject of the relative cost of capital in various industrialized countries was considered in depth at the International Conference on the Cost of Capital, held at the Kennedy School of Government of Harvard University on November 19-21, 1987. A full set of the 17 papers presented is available from our office. Any modification of the tax law that would broadly affect the interest deduction would adversely affect the cost of capital in the United States and thereby worsen our competitive situation. Quantitative analysis of this issue is essential.

4. Revenue effects. The revenue effects of leveraged buyout transactions under current law are unclear. The Treasury Department has testified that at least in the short term, leveraged buyout transactions do not cost the Treasury revenue.[4] A prominent economist at the Harvard Business School has analyzed the revenue effects of buyout transactions and has concluded that they result in a net revenue gain to the Treasury, even on a

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[4] See Testimony of Secretary Nicholas Brady, Ways and Means Committee, January 31, 1989.

present value basis.[5] No Joint Committee revenue estimate has yet been released. In any case, concern has been expressed that "over-leveraging" is likely to "erode" the corporate tax base in the future. While this concern may be difficult or impossible to quantify, any legislation designed to remedy this perceived concern must be critically analyzed in order to assess its impact in the short and medium term to Treasury revenues. Any solution to long term concerns obviously is not viable if it produces short term revenue harm due to market reaction.

5. Transition rules. Transition rules would be particularly difficult in the case of legislation that would attempt to modify the current law distinction between debt and equity. Businesses have been financed with indebtedness long before the income tax was instituted in 1913. If some new limitation were now to be imposed on the deductibility of business indebtedness, it may be appropriate to grandfather existing debt which was created with the expectation of deductibility based on current law. However, a permanent grandfathering of existing debt would create inherent unfairness, since a new company which borrowed to finance its business would be subject to the new limiting rule, but would be competing against older businesses with grandfathered indebtedness. If grandfathering for existing debt only applied for a window period, with some interest expense disallowance after that period, unfairness would also be created, particularly for long-term debt: reasonable expectations at the time the debt was incurred would be frustrated after the window period. Such a rule would probably involve massive refinancings when the window period approached, with likely resulting turmoil in the capital markets.

If such a window approach were adopted, other difficult issues would include dealing with revolving credit or unused credit lines that were in place but not in use on the date of enactment. Similarly, repayment of debt followed by the institution of new debt, which often occurs in a normal business cycle, would be dramatically altered for purely tax reasons.

* * * *

In summary, we believe that the parameters of current case law should be fully considered before any legislative effort is made to limit in any way the deductibility of interest. If the Committee wishes to consider legislative proposals, we recommend that each be scrutinized as to its impact on U.S. competitiveness, financial institutions, Treasury revenue, cost of capital, and transition rules. We would be pleased to answer any questions about Clayton & Dubilier transactions or about any specific legislative proposals.

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[5] See Testimony of Michael C. Jensen, The Effects of LBOs and Corporate Debt on the Economy, Ways and Means Committee, February 1, 1989; Michael C. Jensen, Steve Kaplan and Laura Stiflin, "Effects of LBOs on Tax Revenues of the U.S. Treasury," Tax Notes, February 6, 1989.

Mr. GIBBONS. Thank you, sir.

Let's see, we go now to Mr. Scherer.

STATEMENT OF FREDERIC M. SCHERER, PH.D., PROFESSOR OF POLITICAL ECONOMY, SWARTHMORE COLLEGE, PA

Mr. SCHERER. Thank you, Mr. Chairman.

Mr. GIBBONS. Go ahead.

Mr. SCHERER. My name is F. M. Scherer. I'm professor of economics at Swarthmore College.

It's a pleasure to be here, especially when one considers the alternative—in a less enlightened era, filling out one's tax forms furiously on March 14.

My testimony, which I'll submit for the record, attempts to illuminate the——

Mr. GIBBONS. That's before the law became as complicated as it is now.

Mr. SCHERER. That's right.

Mr. GIBBONS. We need to stretch it until about December, I think. [Laughter.]

Go right ahead.

Mr. SCHERER. In my testimony I try to illuminate the effects of leveraged buyouts and going private transactions. What I find is both good news and bad news.

The good news is that there are increases in short-run operating efficiency following highly leveraged transactions. For the divisional selloffs covered by my own case study and statistical analyses, the reasons for these efficiency increases were complex.

In part, what was happening was that the new structure was simply undoing the adverse effects of earlier, poor-fitting mergers. More recent work, however, on whole company going—private transactions supports another finding of ours, namely, that the pressure of debt service obligations and the incentives created by substantial management stock ownership positions also work to stimulate operating efficiency.

The bad news comes in two installments. For one, these findings suggest a failure of prevailing large corporation governance systems. Managers are not being goaded to run the tightest ship possible and to maximize stockholders' wealth.

So, what we are seeing in part is a replacement of traditional ownership structures that haven't been working as well as they should, with those that have stronger incentive effects.

Perhaps even more importantly, however, high leverage increases the risk that the overall economy bears. Debt levels in the industrial sector of the U.S. economy right now are high relative to historical trends. Indeed, they are high relative to the late 1920's; they are about as high as they were in the public utility sector in 1929, which got into tremendous financial crises when the depression of 1929–33 hit.

When and if we have a serious recession, many highly leveraged companies will be under severe pressure to cut their investment and research and development outlays more sharply than they would have, had they been less leveraged. These investment cutbacks will intensify the recession. It is not clear that the Federal

Government will be in a position to implement effective countercyclical measures under these circumstances, given its own budget deficit problems, the dependence of the United States on foreign investment flows, and the general vulnerability of the dollar.

That is the essence of my testimony.

What should be done about this problem? I am not optimistic that much can be done on the tax front. Recent tax reforms during the 1980's have redistributed substantial wealth to the wealthiest stratum of our society. The most obvious measure, which on its face is a very good measure, that is to say, making dividend payouts tax deductible at the corporate level, would aggravate the inequities that have been built in by the 1980's tax reforms. So unless you can cure two problems at once, I do not think you can use tax reforms to solve this particular problem.

At least as promising would be a restructuring of corporate governance mechanisms. Many of the regulatory actions that would be needed are the jurisdiction of committees other than Ways and Means. But it seems clear that one needs to build in new incentive structures, among other things, making directors' compensation dependent upon the long-run fortunes of the corporation, not simply this month's fee for attending a meeting. Here I think there would be substantial issues on which the Ways and Means Committee might make a substantial contribution.

Thank you.

[The statement of Mr. Scherer follows:]

Statement of

F. M. Scherer

before the

COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES

March 14, 1989

It is a pleasure to assist the Committee in its inquiry into the tax policy aspects of mergers, acquisitions, and similar business restructurings. I appear at the Committee's request on my own behalf and do not represent any group or organization.

Mergers, Profits, and Efficiency

My principal perspective on the matter comes from a five-year study of mergers and sell-offs with National Science Foundation, Federal Trade Commission, and Brookings Institution support. My co-author in the project was David J. Ravenscraft of the University of North Carolina. The findings from our research were summarized in a book, Mergers, Sell-offs, and Economic Efficiency, published in 1987 by the Brookings Institution.

Our study had several unique features. Perhaps the most important was tapping the Federal Trade Commission's Line of Business financial reports data for the years 1974-77, permitting us to track mergers to the narrowly-defined units in parent corporations where they were located organizationally, and thereby to study in detail how the financial performance of lines with an intensive merger history differed from lines originating largely through internal growth and development. Altogether, we linked roughly 6,000 mergers occurring between 1950 and 1975 to 4,409 manufacturing industry "lines of business" operated by 471 U.S. corporations. Most of the mergers took place in the late 1960s and early 1970s, during the third great merger wave in American economic history. (The earlier waves peaked in 1901 and 1929.) A similar study is not possible for the fourth great merger wave, occurring during the 1980s, because the collection of Line of Business financial information was discontinued after 1977.

We found that for the most part, the mergers of the 1960s and early 1970s were not very successful. Before being acquired, the target firms were quite profitable -- more profitable on average than similar non-acquired firms in the industries they inhabited. The smaller the acquired firm, the more its pre-merger profitability exceeded industry norms. Tender offer targets were somewhat different; their profitability averaged 8 percent below home industry norms in the two years before a tender offer takeover attempt commenced.

Following merger or takeover, the acquired units' profitability fell on average. Of the units that remained with their new parents, there were three main reasons for the decline in profitability: the stepup of asset values (reducing operating income-to-assets ratios) owing to premiums paid over pre-merger book value; the non-sustainability of unusually high pre-merger profit rates; and less effective management of the acquired units after they moved from independent status into a more complex conglomerate organization. Takeover targets, however, showed no tendency for post-merger profitability either to decline or rise on average after correcting for asset revaluation effects. Although individual exceptions existed, our statistical materials provided no support for the assertion that acquired unit operating efficiency rises on average after acquisition.

The Economics of Sell-Off

However, much more compelling evidence of post-merger managerial failure came to light in connection with the entities that were acquired and later sold off by their new parents, and especially by conglomerate parents (that is, parents whose specialty was a quite different line of business than that of the acquired units). The sold-off units had pre-merger profitability statistically indistinguishable from that of units which were acquired and retained through the year 1981. In the year before divestiture commenced, the operating income / assets ratio of lines about to be sold off was minus 1.09 percent on average, in sharp contrast to the plus 13.93 percent average return of units not sold off in the 1974-81 period. Nor was such loss-making activity a rarity. By our best estimate, 46.6 percent of acquisitions consummated during the 1960s and early 1970s ended eventually in sell-off or divestiture.

We conducted field case studies of 15 acquired units that were subsequently sold off by their acquirers. Some of the performance failures that led to sell-off, we discovered, were triggered by the turbulent economic conditions of the 1970s, often aggravated by the inability of conglomerate parent management to discover what the root problem was and to implement timely correctives. In other cases, complex organizational structures, the difficulty of maintaining incentives for good operating level management performance, and parent demands for short-run results that could not be sustained over the long run were causes of failure and sell-off.

When business units acquired during the 1960s and early 1970s got into trouble and were divested, they were most commonly sold off to another company. Quite typically, they moved thereby from a conglomerate organizational structure into a horizontal merger (where the new parent operated in the same industry) or one in which there was a vertical buyer-seller relationship between the parent and the new subsidiary. On average, our statistical analysis revealed, financial performance improved following this change. A less typical but increasingly important form of divestiture was into a leveraged buyout, usually with a high level of debt and substantial operating-level management participation in the new enterprise's equity ownership. Since the sold-off LBO units typically "went private," we have no systematic statistical data on their post-divestiture performance. Case studies of several such restructurings revealed that after sell-off, the new managements implemented a broad and impressive array of efficiency-increasing measures. However, three of the sold-off LBO units were in such desperate shape at the time of sell-off, and/or were so heavily burdened with debt, that they failed and ceased operation. One other sold-off unit was closed by its new parent, and its equipment was transferred to a plant in another state.

The New Merger and Sell-Off Wave

With only a few exceptions tracked by our case studies, our research ended with sell-offs taking place in the year 1981. However, our research is directly relevant in one respect to the merger wave that followed during the 1980s. Some of the "bust-up" takeover activity that has become prominent in the 1980s was motivated in part by the same kinds of problems we studied in detail. That is, conglomerate corporations were operating numerous divisions, some requiring skills alien to those possessed by the conglomerate's management and performing relatively poorly. Because of the ill fit between parent and subsidiary, the subsidiaries were worth more standing alone, or in the hands of a new and more closely related parent, than they were as part of the conglomerate. The desire of parents to ward off takeover by getting rid of such subsidiaries, or the decision of acquirers to "bust up" an ill-fitting organization that was slow to divest, has been a prominent feature of merger activity during the 1980s. Many such restructurings are recorded simultaneously as sell-offs and mergers. For every 100 mergers reported by W. T. Grimm & Company over the period 1980-87, 37.5 divestitures were recorded.

The 1980s have also witnessed a new phenomenon similar in some ways to the creation of LBOs through divestiture, but different in others. That is the "going private" transaction, when a whole company, not just some subsidiary, is reorganized and established with a highly-leveraged financial structure. Indeed, from data published by W. T. Grimm & Co., whole company "going private" transactions bulk larger than divisional buyouts, as the following tabulation shows:

Year	Value of Recorded Divisional LBO Transactions ($ millions)	Value of Whole Company Going Private Transactions ($ millions)
1979	47	636
1980	363	967
1981	484	2,339
1982	1,361	2,837
1983	2,499	7,145
1984	3,833	10,806
1985	5,005	24,140
1986	9,542	20,232
1987	5,957	22,057

The year 1989 will no doubt set a new record for going private transactions on the strength of the RJR Nabisco deal alone.

Sell-Offs and "Going Private" Transactions

Going private transactions are similar to the leveraged divisional sell-offs covered by our case study research in two respects: a high level of debt financing is typically assumed, and the new management, which is often the previous operating-level management, acquires an important equity stake in the enterprise. They are different in two other ways. For one, the whole companies that go private were often sustaining good financial performance before restructuring, whereas the divisional sell-offs covered by our statistical sample and our case study research were typically performing poorly. For many of the divisional sell-offs, the mandate was "improve or die." Also, with the divisional sell-offs, a substantial simplification of organizational structure usually occurred, whereas with the whole company going private transactions, the organizational structure remained essentially unaltered, at least initially.

From these differences, one might suppose that performance improvements would have been more likely to emerge following divisional as contrasted to whole-company LBOs. I have no comparative data on this point, nor do I know of any. However, Professor Steven Kaplan of the University of Chicago has conducted an impressive study of the financial performance of some 76 companies that were taken private by their managements in the 1979-85 period, and for which (an important limitation) published data were available. He found that after controlling for changes in over-all industry conditions, operating income as a percentage of assets improved relative to pre-restructuring values by 1.8 percentage points in the year after restructuring and by 5.6 percentage points in the second year after restructuring.

In this important respect, Kaplan's findings parallel those by Ravenscraft and myself. Going private led to operating cost savings and increases in operating profitability. But with Kaplan's sample, the behavioral changes appear to have been precipitated by changes in capital structure and managerial ownership participation only, whereas for our sample, there were organizational changes and a history of poor past performance too.

The implication of this research is that the pressure of heavy debt service obligations, and/or the recognition that improvements in profitability will be rewarded by substantial increases in the value of management's stockholdings, makes management run a tighter ship. This is good news in one respect, but it is bad news in another. It suggests that the top managers of large "public" American corporations, despite being paid an average of $685,000 in salary and bonuses in 1987 (according to Business Week's October 21, 1988 survey of the 1,000 most valuable public corporations), are not on average running as tight a ship as they might. (In contrast to the situation in LBO companies, only 77 of the top 1,000 public companies' CEOs owned 10 percent or more of their wards' common stock.) Thus, the evidence may be pointing to the persistence of a problem identified by Adolf Berle and Gardiner Means in a famous 1932 book: the top management of large public corporations is less than fully diligent in striving to maximize profits and thereby to serve the interests of absentee owner-stockholders.

The Problem of Long-Term Investment

One caveat must be brought out before I move the argument forward. The operating profitability of a company can be increased by cutting fat, or by cutting muscle and bone. From extended observation, I do not doubt that there is fat to be cut. But there is also reason to believe that the pressure-cooker environment of a highly leveraged buyout also leads sometimes to expenditure reductions, e.g., for research and development and investments likely to pay off only slowly, in ways that impair long-term strength. A recent National Science Foundation study revealed, for example, that eight large companies involved in leveraged restructurings reduced their R&D spending between 1986 and 1987 by 12.8 percent on average, while 176 companies subjected to no significant mergers or restructuring increased their spending by 5.4 percent. Perhaps even more important, but more difficult to observe, companies with pricing discretion may be tempted to set product prices high and harvest substantial profits in the short run, accepting long-term market share losses as the entry and expansion of foreign and domestic competitors are stimulated. The managers who cut back investment spending following the LBOs covered by our case studies "expressed unease and hope that, once their debt burdens became lighter through repayments, they would be able to invest more in future-building activities." Mergers, Sell-offs, and Economic Efficiency, p. 155. But very little is known about the extent to which heavy leverage and the incentives of the "going private - going public" cycle lead to real sacrifices of long-run economic strength.

The Macroeconomic Risks of Leverage

To the extent that operating efficiency and profitability are higher under heavily leveraged financial structures in which managers have substantial equity positions, we can expect the going-private phenomenon to continue. But if it does, there are clear risks to the U.S. economy as a whole. Sooner or later, we are going to experience another serious recession. It could come from deliberate Federal Reserve Board actions stronger than the ones underway now or from a sudden flight from the vulnerable dollar. If the rise in interest rates (ratcheting short-term financing costs upward) and the decline in economic activity with the onset of recession cause cash flow problems for numerous leveraged companies, those firms' managers will have to take stern measures to avoid default. It is almost certain that they will react by cutting real plant, equipment, and R&D investment more than they would had they been less heavily burdened with debt. That incremental fall in real investment (in addition to the drop that always accompanies recession) will in its own right deepen the recession. And as additional workers in the capital goods industries lose their jobs, their spending on consumption will fall, with the negative multiplier effect reverberating through the economy. In short, a recession in a heavily leveraged economy is almost certain to be more severe than one in an economy populated by corporations whose financial structures have more shock absorption capability.

Although other factors played a more important role, such a debt-induced reaction is believed to have contributed to the severity of the 1930s depression. To see how the situation now compares to that of 1929, I assembled data on the ratio of debt as a percentage of the book value of debt plus stockholders' equity for 1929 and the first quarter of 1988. The comparisons are as follows:

	1929	1988
Manufacturing sector	15%	39%
Mining sector	15%	49%
Retailing sector	23%	50%
All three combined	17%	40%
Public utilities	42%	n.a.

The degree of leverage built into manufacturing, mining, and retailing corporation capital structures last year was much higher than it was in 1929. It approaches the leveraging of 1929's public utilities sector, which was the paramount locus of subsequent financial failure!

Although the coverage of debt service obligations by cash flow seems adequate for most corporations under currently prosperous conditions, that situation could change rapidly when a significant recession occurs. In a simulation analysis, Professors Ben Bernanke and John Campbell of Princeton University found that if recessions as severe as those of 1975 or 1982 were to take place, ten percent or more of the large public firms on which data are available would be pushed into bankruptcy. Brookings Papers on Economic Activity, 1988, no. 1, p. 121.

To the argument that we are approaching a peril point, two counter-arguments can be raised. For one, the economy is more stable intrinsically now than it was in 1929. We know more about how to combat recession, and we have more automatic stabilizers such as the income tax and unemployment compensation. This is true, but our flexibility to act upon the knowledge we possess is declining. If a recession hits, the Federal deficit is likely to balloon quickly into the $200 billion-plus range. Will we be able to take aggressive counter-cyclical fiscal measures under those conditions? Our newly-won position as a net debtor nation also limits our flexibility. If the Federal Reserve were to react by massively creating reserves, any sharp counter-cyclical decline in real interest rates would drive the dollar lower, and fears of inflation could trigger a run against the dollar.

It is also argued that extensive leveraging of U.S. industry is acceptable because other nations, such as Japan and Germany, have long had much more industrial leverage than we, and they have survived macroeconomic shocks well. But there is an important difference. In Japan, when financial crisis looms, the government, powerful banks, and industry work together to ensure that a financial rout is avoided. Affiliated companies bail each other out, recession cartels are authorized, import restraints are imposed, and so on. In West Germany, the Big Three of banking have wielded sufficient power to prevent ordinary shocks from being aggravated, and government-industry-bank cooperation, although less close than in Japan, can be expected to facilitate concerted action against larger shocks. We in the United States have a different, more decentralized, more adversarial system. Unless we are willing to make significant changes in that system, it is unlikely that we would be able to deal with the interacting problems of recession and high leverage as quickly and effectively as Japan and Germany.

Possible Remedies

Thus, I see serious risks in a continued movement toward the leveraging-up of American industry. The question remains, what should be done?

One approach would be to discourage debt financing and/or encourage equity financing by revamping the tax structure. I have long favored exempting corporate earnings paid out as dividends so that they are taxed only once, when received by stockholders. But if this change were to be adopted in isolation now, the distribution of income would be skewed even more sharply in favor of the wealthiest stratum. If they perceived what was happening, ordinary taxpayers would protest with their voices and their votes against such a continuation of the redistributions initiated in the 1981 and 1986 tax acts. I could support the change only if the marginal rates for higher-income taxpayers (including myself) were adjusted upward sufficiently to achieve a revenue-neutral result.

A revenue-neutral outcome might also be attained by reducing by some fraction the tax deductibility of interest and exempting a commensurate fraction of paid-out dividends from taxation. I know too little about the precise effects of marginal tax changes on merger and going-private transactions to predict the extent to which heavy leveraging would be discouraged thereby.

Proposals have also been advanced to eliminate the tax deductibility of interest on debt that exceeds some stated fraction of total capitalization, or on debt that is used in certain kinds of takeover and going-private transactions. I suspect that implementing such an approach would be an administrative nightmare, violated inter alia as clever financiers and attorneys discover diverse loopholes and dodges. Small businesses heavily dependent upon debt financing might also be hurt disproportionately by such changes.

Some of the speculative behavior that encourages takeovers and going-private transactions would be discouraged if capital gains on short-term stockholdings (e.g., on shares sold before a holding period of two years elapses) were taxed more heavily than on long-term holdings. If President Bush's proposal to restore the differential taxation of capital gains is considered by the Congress, I would urge that an appreciable holding period (much more than the previous six months) be required. Ideally, that change would be coupled with the indexing of asset bases for inflation, as urged by the "Treasury I" study some years ago. I would also advocate applying a significant capital gains tax to sales by pension funds and other tax-exempt intermediaries when common stocks are held less than a year.

Finally, if the findings of Kaplan are sustained by further, more comprehensive research, it must be recognized that the incentives for going private stem at least in part from a failure of traditional public corporation governance mechanisms. Going private alleviates an incentive problem, which is good, but it carries in its wake a serious macroeconomic risk. A better approach would be to attack the corporate governance problem directly -- e.g., through reforms that force outside directors to take their responsibilities more seriously. Among other things, a substantial fraction of directors' compensation could be made contingent upon the long-term (e.g., five-year) common stock performance of the companies on whose boards the directors sit. I do not doubt that such changes would among other things raise numerous problems directly within the Ways and Means Committee's jurisdiction.

Mr. GIBBONS. Thank you. Now we have two gentlemen from Boston University, Mr. Michel and Mr. Shaked.

STATEMENT OF ALLEN MICHEL, PH.D., ASSOCIATE PROFESSOR, AND ISRAEL SHAKED, PH.D., ASSOCIATE PROFESSOR, BOSTON UNIVERSITY, SCHOOL OF MANAGEMENT

Mr. MICHEL. Mr. Chairman, both of us are professors at Boston University, School of Management. Our insights result from 10 years of studying mergers and leveraged buyouts, including numerous articles and two books, the most recent of which is "The Complete Guide to a Successful Leveraged Buyout" published recently by Dow Jones. We appreciate your invitation to speak before this committee.

We wish today to present testimony suggesting that the market forces and already available judicial and regulatory powers are sufficient to prevent any excesses and abuses caused by leveraged buyouts. We wish to indicate that many of the problems associated with leveraged buyouts are at best pure speculation and likely to be proven false on closer examination. In addition, we believe that any action taken by Congress to reduce the possibility of U.S. firms doing leveraged buyouts will have serious and detrimental repercussions.

We would like to go over several questions one by one and both of us will handle several of the issues.

One, does the Treasury benefit or lose as a result of LBO's. First, it is certainly true that the tax deduction of interest reduces the tax revenues collected from ongoing operations of LBO companies in the short run. However, considering all sources of tax revenues, a significant net gain accrues to the Treasury as a result of leveraged buyouts.

The gains accrue basically from four sources. First, capital gains received by selling shareholders. In the year of the buyout, selling shareholders are taxed on the proceeds of the sale. The second is sales of assets and divisions of subsidiaries. As such, dispositions are typical of LBO's in the year following the LBO.

The third is interest payments to the purchasers of LBO debt. By definition, significant interest obligations are created as a result of the LBO. And while payments are deductible to the payor, they are in most cases taxable to the recipient. Last, gains received by equity participants in the LBO. Over time as new shareholders dispose of their investments taxable gains do result.

The next issue that we would like to discuss is what judicial and regulatory remedies are currently available to limit the risk of future LBO defaults. The most potent judicial remedy to curtail excessively risky LBO's is that of the fraudulent conveyance judgment. The remedies are potent enough to ensure the careful assessment of an LBO loan. In particular, if a fraudulent conveyance is determined to exist, all loans and securities received by the lending institution may be set aside.

In other words, a secured lender can find its collateral subordinated to the claims of firms' unsecured lenders. The selling shareholders can also be detrimentally affected by fraudulent conveyance litigation. More specifically, to the extent that selling shareholders knew that the management team purchasing the firm would become insolvent following the transaction, the selling shareholders may be required to return a portion of the price paid to them in the event of default.

Mr. GIBBONS. Is that currently the law?

Mr. MICHEL. That currently is the law, that is correct. Because of these serious implications, both lenders and advisors are becoming familiar with the fraudulent conveyance issue. As more players in the LBO arena learn of the potential consequences of fraudulent conveyance, LBO lending and the risk-taking will no doubt be more carefully scrutinized. The seriousness of having a transaction be deemed a fraudulent conveyance is likely to cause lenders to rethink their lending policies in a highly leveraged acquisition situation.

Today lenders generally are aware of fraudulent conveyance law. However, because of the few failures to date it has not yet gained the visibility and consequential power that it is likely to generate in the future. Once it does, banks are likely to be particularly cautious about LBO lending. The severity of the consequences leaves them no alternative.

On the regulatory side, the Federal Reserve Board has recently tightened its lending guidelines for leveraged buyouts. The Fed recently established a 3-to-1 debt-equity ratio above which lending will be considered highly leveraged lending. In a letter to banking organizations involved in LBO lending the Fed suggests: One, doing a what-if analysis under various economic scenarios. Two, setting bank limits on industry concentration and total LBO lending. Three, maintaining an effective set of internal controls to monitor bank compliance with the second issue. And last, avoiding bad banking practices associated with excessive LBO lending in order to generate increased fees to gain market share.

Now, another issue that we want to address is: Is the banking system at risk because of overextending LBO lending? We believe it is not. First, because prudent lending requires the diversified base of industries represented in a bank's LBO portfolio. Second, bank lending is typically senior, collateralized lending based on prudent analysis of cash-flows. Typically the loans are collateralized by approximately 80 percent current accounts receivable, 50 percent of finished goods inventory, 80 percent of liquidating value of equipment, and 70 to 75 percent of real property.

Third, even in those instances where defaults do occur and where the margin of safety is not sufficient to completely protect the bank's position, default rates do not provide an appropriate measure of bank loss rates. For example, a default may occur yet a bank may well still collect a sizeable percentage of the principal and interest owed to it, say 80 or 90 cents on the dollar.

Now what are the likely effects if Congress limits leveraged buyout activity? Let me just conclude by discussing that issue. What I would like to say here is that if, in fact, financial incentives for LBO's are not maintained the primary effect is that foreign acquirers will obtain a decided competitive advantage in the acquisition process. Congress will unintentionally globalize the ownership of corporate America.

Thank you.

Mr. **Gibbons**. Thank you. That is interesting testimony. You have brought up some questions I had not thought about.

Mr. Shaked.

Mr. **Shaked**. I would like to say a few words about are there any benefits to maintaining the opportunity to do LBO's. We did some research where we compared the financial characteristics of companies that did an LBO and comparable firms in the same industry that did not do an LBO.

We found two interesting things. First of all, the asset turnover, which means the sales per dollar of assets—and we are talking about the same industry—was much lower for a firm that did an LBO. Which means that prior to the LBO they were less than an average performer in the industry. This is one interesting point. This was very significant because they were outnumbered by a factor of 7 to 1 in 3 out of 4 years that we looked at.

A second one is the return on assets. Not only do they generate less sales, but also the profit per dollar of assets is lower. So on both profitability and asset utilization, LBO's were definitely not the crown jewels of the industry. They were less than average.

In addition, we would like to say a few words about R&D, layoffs, and employment. We did some work on comparing LBO's with non-LBO's. We thus far have not found any significant results, although we did not complete the study, but we have some of them. The gentleman in the morning from the National Science Foundation talked about under-research in LBO's. I do not challenge or question the reliability of his figures, but his result is based on eight LBO observations. He has only eight firms in his analysis. That is a pretty small number to conclude any statistically significant result.

Indeed, we looked at many LBO's. There are often spinoffs, with some short-run decline in employment. However, we do know about at least one research study where average employee growth prior to the LBO was 2.3 percent and it increased to 4.2 percent following the LBO.

So we do not have to look at the companies that went to the LBO and what happened to all the divisions that have been sold. That is another aspect that most other research really leave out.

The question of bond holders, are they unfairly penalized? We think that by now most risks are already incorporated in the yields. Someone who buys a junk bond should know that this is not a safe investment. It is not a U.S. Treasury bill. The risk is already incorporated in the yield. So we do not believe that any regulation or tax related changes will be beneficial.

The last thing that we want to say a word about, are there any areas, not necessarily tax related, where we think that leveraged buyouts can be affected or might be amended by the Congress. The only area that it might be potentially beneficial is the idea that money center banks in New York are creating a large volume of loans, and then selling off major fractions of these loans to other smaller banks, which are less sophisticated. The small bank usually relies on the money center bank to do the analysis.

Now that is very interesting. The large bank sells most of the loan. So the incentive is small to do a real due diligence analysis. The small bank does not have the personnel nor the information to do any due diligence. For example, Bankers Trust currently has about $2.7 billion of buyout loans on its books but originated about $60 billion in the last 3 years. So most loans are really resold to other banks. Someone must be held responsible to make sure that their originator has the proper incentive to do the due diligence.

Besides that, we would like to see the leveraged buyout arena unchanged. We do not think that the Congress can sit in Washington and make any rules to differentiate between good and bad, or hostile or friendly mergers or leveraged buyouts. I do not think that we are able to formulate any framework that will come up with such a result.

Thank you.

[The statement of Mr. Michel and Mr. Shaked follows:]

Leveraged Buyouts: Evaluating the Issues

Testimony to the House of Ways and Means Committee

March 14, 1989

Allen Michel
and
Israel Shaked

Mr. Chairman, we appreciate your invitation to speak before this committee.

Much has been said in the popular press and before Congress about the excesses of leveraged buyouts. These excesses have been identified with the following set of problems: unmanageable debt burden, increased risk of default, reduced flow of funds to the treasury via taxes, significant unemployment as a result of the LBO, reduced capital expenditure and research and development outlays, excessive risk to financial institutions making LBO loans, undue risk to pension funds investing in LBOs and an unfair penalty to existing bondholders.

We wish to present testimony suggesting that the market forces and already available judicial and regulatory powers are sufficient to prevent any excesses caused by leveraged buyouts. We also wish to indicate that many of the problems associated with leveraged buyouts are at best pure speculation and likely to be proven false on closer examination. In addition, we believe that any action taken by Congress to reduce the possibility of U.S. firms doing leveraged buyouts will have serious and detrimental repercussions.

We would like to address the areas of concern, on at a time.

* Does the treasury benefit or lose as a result of LBOs?

There has been much myth and hypothetical discussion surrounding LBO activity. It is certainly true that the tax deduction of interest reduces the tax revenues collected from the ongoing operation of LBO companies in the short-run. However, considering all sources of tax revenues a significant net gain accrues to the treasury as a result of leveraged buyouts. The gains primarily result from four causes.

a.) Capital gains received by selling shareholders. In the year of the buyout, selling shareholders are taxed on the proceeds of the sale.

b.) Sales of assets, divisions, or subsidiaries. Such dispositions are typical in the year following the LBO. Any resulting gains over the basis of the assets sold are taxed.

c.) Interest payments to the purchasers of LBO debt. By definition, significant interest obligations are created as a result of an LBO. While payments are deductible to the payor, they are, in most cases, taxable to the recipient.

d.) Gains received by the equity participants in the LBO. Over time, as the new shareholders dispose of their investment, taxable gains result.

* **What judicial and regulatory remedies are currently available to limit the risk of future LBO defaults?**[1]

The most potent judicial remedy to curtail excessively risky LBOs is that of a fraudulent conveyance judgement. The remedies are potent enough to ensure the careful assessment of an LBO loan. In particular, if a fraudulent conveyance is determined to exist, all loans and security received by the lending institution may be set aside. In other words, a secured lender can find its collateral subordinated to the claims of the firm's unsecured creditors. The selling shareholders can also be detrimentally affected by fraudulent conveyance litigation. More specifically, to the extent that selling shareholders knew that the management team purchasing the firm would become insolvent following the transaction, the selling shareholders may be required to return a portion of the price paid to them in the event of default. Because of these serious implications, both lenders and advisors are becoming familiar with the fraudulent conveyance issue. As more players in the LBO arena learn of the potential consequences of a fraudulent conveyance, LBO lending and risk taking will no doubt be more carefully scrutinized.

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[1] Much of the response to this question is based on a working paper, "The LBO Nightmare: Fraudulent Conveyance Risk" by Allen Michel and Israel Shaked, Boston University's School of Management, 704 Commonwealth Avenue, Boston, Massachusetts, 02215.

For a court to determine that a fraudulent conveyance occurred, two requirements must be met.

First, the target firm involved in the LBO must not receive "reasonably equivalent value" or "fair consideration" for any liens it provides to a lending institution. In most LBOs, the funds go directly from the lender to the selling shareholders, with the target firm or holding company set up to do transaction acting merely as a conduit of funds. The result is that the firm typically is left with none of the proceeds itself. The firm, to the detriment of the unsecured creditors, thus incurs an obligation to repay the bank, yet it receives nothing in return.

The second requirement for a fraudulent conveyance deals with the issue of undercapitalization. It requires that the LBO transaction results in insolvency or inadequate capitalization. Assessing whether the firm is inadequately capitalized will depend on financial forecasts and analysis prior to the LBO. To the extent that the unsecured creditors can prove that the lender should have recognized the firm's potentially insolvent condition, a fraudulent conveyance is deemed to have occurred.

The seriousness of having a transaction be deemed a fraudulent conveyance is likely to cause lenders to rethink their lending policies in highly leveraged acquisition situations. To date, lenders are generally aware of fraudulent conveyance law. However, because of the few LBO failures to date, it has not yet gained the visibility and consequential power that it is likely to generate in the future. Once it does, banks are likely to be particularly cautious about ~~LBO lending~~. The severity of the consequences leaves them no alternative.

On the regulatory side, the Federal Reserve Board has recently tightened its lending guidelines for leveraged buyouts. The Fed recently established a three-to-one debt/equity ratio, above which lending will be considered "highly leveraged financing". In promulgating the new guidelines to banks, the Fed has emphasized the importance of establishing procedures to handle LBO lending and insuring that those procedures are periodically reviewed and evaluated by the bank boards.

In the letter to banking organizations involved in LBO lending, the Fed suggests:

a) doing a "what if" analysis under varying economic scenarios,
b) setting bank limits on industry concentration and total LBO lending,
c) maintaining an effective set of internal controls to monitor bank compliance with (b),
d) avoiding bad banking practices associated with excessive LBO lending in order to generate increased fees or to gain market share.

*** Is the banking system at risk because of overextended LBO lending?**

Those banks which have performed an appropriate due diligence analysis on their LBO portfolios are unlikely to encounter solvency problems resulting from LBO lending. First, prudent lending requires a diversified base of industries represented in a bank's LBO portfolio. Second, bank lending is typically senior, collateralized lending based on a prudent analysis of cash flows.

Such loans are typically collateralized by approximately 80 percent of current accounts receivable, 50 percent of finished goods inventory, 80 percent of the liquidating value of equipment and 70 to 75 percent of real property. In other words, most prudent banks have provided a margin of safety for themselves in developing LBO lending guidelines. Thus, even in a recession, a bank's secured position is not likely to be severely adversely affected. Third, even in those instances where defaults do occur and where the margin of safety is not sufficient to completely protect a bank's position, default rates do not provide an appropriate measure of bank loss rates. For example, a default may occur, yet a bank may well still collect a sizeable percentage of the principal and interest owed to it, say 80 cents on the dollar. Indeed, for much riskier junk bonds, the average default rate between 1974 and 1986 was reported by Perry and Taggart[2] as 1.67% while the weighted average default loss for the same period was reported as 1.10%. In other words, it is likely that the default rate for more senior bank financing is significantly smaller than that of unsecured junk bonds with the resulting default loss smaller yet. Even in the event of a moderate to severe recession, it is our opinion that the banks' positions will largely be protected.

While most lending institutions will find themselves with a sufficient margin of safety, there will no doubt be those that have not followed prudent lending practice. Indeed, the lessons learned from those which fail should be applied in a free and open marketplace of LBO lending. The lessons learned will no doubt be those of careful cash flow analysis and prudent due diligence. However, any defaults should not in any way jeopardize the banking system.

*** What are the likely effects if Congress limits leveraged buyout activity?**

If the financial incentives for LBOs are not maintained, the primary effect is that foreign acquirers will obtain a decided competitive edge in the acquisition process. Congress unintentionally will globalize the ownership of Corporate America. Foreigners, able to deduct interest payments, will obtain a massive tax advantage over U.S. acquirers. Whether Congress decides to limit deductibility of interest paid on junk bonds or place a cap on a borrower's debt-equity ratio, the consequences are the same, increased foreign ownership of U.S. assets. There are no proposals which will have only positive effects and no negative effects. While eliminating the double taxation of dividends is a laudatory goal, the simultaneous removal of some or all of the interest deduction has the net effect of reducing the cost of equity while increasing the cost of debt. Since leveraged buyouts are preponderantly debt financed, such a proposal would likely have the effect of increasing the cost of closing a leveraged buyout. This in turn also provides foreign ownership a competitive financing advantage over U.S. acquirers.

*** What evidence is there that market forces are likely to effect the LBO marketplace?**

As prices of target firms have increased, the Wall Street Journal[3] reports that because of increased risk many large institutional investors have "stopped pumping new money" into such takeovers.

Moreover, well-publicized difficulties in selling off assets after an LBO, have caused potential bidders to rethink their strategy. Beatrice, for example, has attempted to sell numerous units of the company ever since its $6.2 billion leveraged buyout 34 months ago. The staggering $1.9 billion of intangible assets on the company's books has made Beatrice operations particularly difficult to sell.

The market of purchasers of high yield bonds is becoming more sophisticated. In October, 1988 underwriters were forced to pull back an offering of Federated junk bonds after too many investors determined the high yields were not sufficient to cover the risk. Only after terms were appropriately modified, was First Boston able to reissue the bonds.

Because of increased investor perception of risk, with no commensurate increase in returns, investors in LBO funds are becoming more reluctant to ante into the funds. Shearson Lehman Hutton, for example, announced plans for an ambitious $1.8 billion LBO fund in Spring 1988. However, $4^1/_2$ months after funding was to have been completed, they were still $450 million short and of the funds they did collect, more than 50% came from within Shearson itself or its principal shareholders.

Junk bond funds, as well, are failing to attract the interest they once enjoyed. In November, 1988, for example, a new fund offering fizzled. USF & G Pacholder Fund, Inc. planned to raise $150 million, but only raised approximately 25% of its target amount or $36 million. While this fund was a particularly risky fund, it is indicative of the market's growing caution about doing leveraged buyouts.

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[2] Kevin Perry and Robert Taggart, "The Current Role of Junk Bonds in Corporate Finance," working paper, 1989.

[3] Wall Street Journal, November 9, 1988, page C1.

* **Is there any clear benefit to maintaining the opportunity to do LBOs?**

Yes, there are several. In a study of financial characteristics which differentiate those firms which do LBOs from those which have not undergone a buyout, Michel and Shaked[4] find that the return on assets prior to a buyout of those firms doing an LBO is materially lower than a control group of non-LBO firms. When looking at asset turnover the results are even more pronounced. Prior to the LBO, the LBO candidates are significantly less efficient in utilizing their assets. The matched pairs where LBOs have a higher asset turnover are outnumbered by a factor of 7-to-1 in 3 of the 4 years prior to a buyout.

The implication of these results is clear. Investing groups are locating firms whose asset base is excessive and in the post-LBO period are likely to strive to develop competitiveness in their LBO targets. Indeed, asset utilization is the major characteristic differentiating LBO firms from those firms in the same industry not doing an LBO.

LBOs provide a means by which competitiveness of these firms can be developed. If Congress reduces the incentive to buy these companies and make them efficient players in the world marketplace, the only winners are foreign investing groups and foreign firms, who with their strong currencies, available financing and conducive tax structure will purchase many of the firms which previously might have been candidates for LBOs.

* **What is the effect on such important characteristics as layoffs, R&D spending, and capital expenditures?**

There is no documented evidence to our knowledge that LBOs have a long-run deleterious effect on the number of employees, R&D spending or capital expenditures. Indeed, investing groups attempt to make their LBO acquisitions profitable and efficient. In doing so, some may sell divisions or units and may initially cut employment. Buyers of the divested units are investing because of the promise of those units. They are unlikely to permit them to languish. In fact, they have every incentive to make productive investments in those units to generate a satisfactory rate of return. These buyers of the divested units are likely, over time, to increase productivity, increase profitability and as a result to increase investment and R&D which should further stimulate profits. The benefit to the economy is increased employment, increased disposable income, and both increased state and federal tax revenues as the firm continues to prosper. Without the LBO, the unit would likely have continued to survive, but not as an efficient, productive organization. Similar arguments can be made for the LBO target itself. The investors are likely to cut fat initially and increase the productivity of the firm. While in the short-run layoffs are a realistic possibility, the alternative is less beneficial to our economy and the firm. Without cost cutting and possibly employment cutbacks, the firm would continue to be a bloated, inefficient, high cost producer. In the long-run, such firms will be dominated by leaner, more productive enterprises which could be either U.S. based or foreign. Preventing the buyouts by reducing the tax benefits to accomplish them, may in the short-run save marginal employment but in the long-run creates an inefficient firm unable to compete effectively. In fact, such a firm has an increased probability of going into Chapter XI at some future point in time. While the leveraged buyout no doubt increased the financial risk in the short-term, it generally provides both operational and financial stability over the long-term. On the other hand, such an inefficient organization not undergoing an LBO or takeover is plagued by significant operational risks in both the short and long-term, with potentially devastating financial consequences looming ahead.

While little has been documented on the post-LBO characterization of firms, Kohlberg Kravis Roberts and Co. (KKR) demonstrated that in its portfolio of companies both capital spending and R&D spending increased following an LBO[5]. In addition, they find that the average employee growth prior to an LBO was 2.3%, while following an LBO employee growth rates increased to 4.2%.

* **Are bondholders unfairly penalized by a corporation's decision to do a leveraged buyout?**

While bond prices are likely to fall for a firm undergoing an LBO, congressional or regulatory action is inappropriate. Such fears of bond price declines can be alleviated through both appropriate bond covenants and already existing legal remedies. To the extent that bondholders view such protection as important, they have the ability to negotiate tougher provisions in bond covenants. While many existing bondholders were no doubt surprised by the restructuring effect on RJR Nabisco bonds, future bonds can be constructed to ensure repayment at par in the event of a leveraged buyout or similar restructuring.

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[4] Allen Michel and Israel Shaked, The Complete Guide to a Successful Leveraged Buyout, Dow Jones, 1988.

[5] Presentation on Leveraged Buyouts by Kohlberg Kravis Roberts & Co., January 1989.

There are also possible legal remedies associated with a bond price decline resulting from a leveraged buyout. These remedies relate to the issue of fraudulent conveyance litigation. In the RJR Nabisco case, for example, bondholders may argue that the LBO caused the firm to provide liens, etc. and that it received no compensation in return. The funds received flowed directly to the selling shareholders and as a result did not remain within the organization.

However, even in the event that the fraudulent conveyance litigation in such cases does not prevail, bondholders are not unfairly penalized by a corporation's decision to do a leveraged buyout. Large buyers of bonds typically perform a due diligence and are aware of the possibility of a restructuring or buyout. Yields to the bondholders already incorporate a premium for the possibility that such event risk will be realized.

* Are there any areas relating to leveraged buyouts where Congress should have some input?

Yes. Money-center banks typically sell off major fractions of LBO loans which they originate. For example, Bankers Trust which currently has about $2.7 billion of buyout loans on its books has originated about $60 billion during the past three years. In many cases the vast majority of a particular credit will be sold to smaller, less sophisticated banks. Because the money center bank is keeping such a small percentage of the loan, its due diligence effort may well be not as thorough as it might otherwise be if it were keeping the bulk of the loan. As the loan gets downstreamed to less sophisticated banks, often unable to do their own due diligence, they are relying on the due diligence performed by the money center banks. In other words, the smaller banks may well be purchasing credits that have not been appropriately screened or evaluated. It should be the responsibility of the selling bank, in such situations, of doing an appropriate due diligence enabling the purchasing bank to rely on such information.

Mr. GIBBONS. Thank you very much.

Mr. Moody.

Mr. MOODY. No questions, thank you.

Mr. GIBBONS. I want to thank this panel. Dr. Michel, it has been a long time since I have been out in the business world as a lawyer and some of these laws have gotten on the books without me thoroughly understanding them. You mentioned one there that you were talking about the misvaluation that I am not familiar with. Can you tell me the history of that?

Mr. MICHEL. Fraudulent conveyance legislation has been on the books a long, long time. It is probably the law that puts the most fear into bankers today. I would think that virtually any banker that is up to speed on knowing what the current state of laws is is worried about fraudulent conveyance legislation.

They might, in fact, believe that they are a secured lender. They are lending and have received liens from the target to whom they have lent to. Yet if a deal is deemed to have been a fraudulent conveyance what will happen is that that security will be taken away from them, at least it can be taken away from them. So their secured position is no longer a secured position.

Mr. GIBBONS. Is this based on statute?

Mr. MICHEL. Yes, it is.

Mr. GIBBONS. Are these State statutes or Federal statutes?

Mr. MICHEL. There are approximately 40 States that have enacted the fraudulent conveyance act legislation.

Mr. GIBBONS. That is interesting. Thank God I never made that mistake when I was practicing law.

Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman. Dr. Michel and Dr. Shaked, in your testimony you answer the question, does the Treasury benefit or lose as a result of LBO's. You indicate a significant net gain accrues to the Treasury. That is at odds with the testimony from the Congressional Budget Office. Have you had a chance to evaluate why your testimony might be at odds with others who contend that this is a net cost to the Federal Treasury?

Mr. MICHEL. I have not looked at that testimony. However, what happens is that once you include various pieces of the tax revenue pie that result from an LBO, I think you have more than just the decrease in revenues resulting from the tax deduction that is generated from the debt taken on in the LBO. You have the massive sale of divisions that typically occurs after the LBO. You have the tremendous capital gains that are received by selling shareholders. When you include both of those primarily what you find is significant tax revenue that is received by the Treasury.

I cannot compare this testimony to the other testimony that you refer to because I am not aware of it.

Mr. DORGAN. What is your perspective from which you view LBO's and mergers? I notice you are from Boston University. Have you been involved in consulting contracts and similar activities that would give you a different perspective on LBO's and mergers. With whom have you consulted?

Mr. MICHEL. Primarily by taking a look at LBO's from an academic perspective. I have also been an expert witness, and I am now retained as an expert witness in a case involving the fraudulent conveyance issue. I have been involved with Professor Shaked for approximately 10 years. We have written two books that deal to a large degree with LBO's and mergers.

Mr. DORGAN. Any consulting on LBO's and mergers——

Mr. MICHEL. Yes.

Mr. DORGAN. The reason I ask the question is Dr. Scherer's paper looks like an academic analysis of LBO's and mergers and yours looks like an advocacy paper. There is nothing wrong with that, but I am just trying to understand the perspective from which you evaluate LBO's and mergers.

Mr. MICHEL. The evaluation is primarily from an academic perspective. The answer to your other question is, have we been involved with firms that have been doing mergers and LBO's, the answer is yes. We have been hired by firms to take a look at potential defenses in the way of hostile takeovers and have been hired by firms to take a look at planning for acquisitions. However, that is not the focus of our testimony.

Mr. DORGAN. Someone recently estimated that the fees involved in all of this LBO activity have been enormous. One piece I read recently talked about $5 to $7 billion, and those are 5 or 7 billion reasons why there are some people who do not want anybody to do anything because they are profiting substantially from what is going on today.

I, too, think that all of the testimony has been beneficial. I was out of the room, over on the floor of the House, speaking on a Sudan resolution and did not hear Mr. Rice. I know Mr. Gibbons is waiting to hear what the answer is and then we will act on it.

This is not an easy area to understand. But I am convinced that what is going on is of great importance to the country. Some think it benefits America and some people believe it creates significant problems. Some make the case that there are LBO's that should happen and nobody ought to interfere with them and they are great for the country. I would not dispute that. We have had anecdotal evidence of that and I do not want to do anything that would interfere or injure that.

But, I do want to injure very badly those scavengers moving around our corporate sector trying to figure out how they can take things apart and make money for themselves rather than create new wealth for the country and help make us more competitive.

I do not think it is accidental that this country has become a feed lot for speculation, while you see no hostile takeovers in Japan. Frankly, I think the Japanese probably understand the kind of energy that has been expended in hostile takeovers in this country is not very productive. It is much more productive to spend most of your time trying to figure out how to build better products and sell them at competitive prices. If you are spending your time trying to figure out how to either attack or defend, that is not very good business.

The Japanese understand that, that is why hostile takeovers are not going on in Japan. But it goes on here in an almost unprecedented wave of activity that I think is generally unhealthy for the country.

Mr. MOODY. Would the gentleman yield on that?

Mr. DORGAN. Be happy to yield.

Mr. Moody. We produce four times as many lawyers as the Japanese, but they produce twice as many engineers. Maybe that is part of the focus, or maybe that is the result of their reward system.

Mr. Dorgan. That is a good point. But I think what we need to understand is what is wrong and what is right. We must make a distinction and try and do what is sober and necessary here with respect to regulatory authority and with respect to congressional activity.

I might, Mr. Chairman, finally say to Mr. Scherer, I have read your work and you and I talked by phone very briefly one day. It is interesting work. It is important that that is available to us. I hope that you will continue to update it because I think the most recent interval is of critical importance to those in a regulatory and a legislative body for analysis in the years ahead. So I certainly commend you on your work and hope you will continue it.

Mr. Gibbons. Let me say to my Japanese admirers, it is my observation that their well-paid workers live about like our welfare recipients. If you want to copy the Japanese, follow them.

Mr. Dorgan. Except you just changed the subject. We were not talking about that. What we are talking about is whether or not hostile takeovers make good sense for an economy. I concede the first point to you.

Mr. Gibbons. I think they do. They get rid of the sick and the ill-managed. There are lots of cripples out there. I hate to say, go out and shoot the cripples, but that is what happens in the survival of the fittest. One of you is talking about—I guess it was Dr. Scherer over here who was talking about the fact that there is some lousy management out there. I watch them arrive at the football games in their corporate jets on Saturday and Sunday. I am really impressed that they need those to make those kinds of decisions.

Mr. Dorgan. Are those jets made in Japan or America?

Mr. Gibbons. They are made all over. Most of them are probably made here, I would imagine. But I think you need some scavengers out there to clean up society. Seagulls do a damn good job keeping the beaches clean in my part of the world, and they are the biggest scavengers I know of.

Mr. Mentz. Mr. Chairman, one reason why you do not have many hostile takeovers in Japan or in Europe is because the banks are so heavily integrated with the companies that you cannot find a banker to lend the funds to do a transaction. So without the financing, it does not happen. That may change, but that is the way it is right now.

I think the point you just made is a very valid one—by the way, hostile takeovers are not part of our concern. Clayton & Dubilier has never done one and probably never will. It is very hard to do a hostile LBO; virtually impossible to line up the financing when you are fighting with incumbent management.

But as you say, a hostile transaction does have the benefit of purging the people who cannot manage. I think you will find if you look back when I had just begun at Treasury, Ron Pearlman testified on hostile takeovers in one of the early hearings and basically said the same thing, that it is very hard to distinguish and the Government should not distinguish between hostile and nonhostile takeovers.

Mr. GIBBONS. They just have a different mechanism in Japan. You have a bunch of bankers who run it and over here you have the marketplace running; that's what it amounts to.

Mr. DORGAN. Except, Mr. Chairman, that I think most academicians who think through this, I think most people who have a good sense of business and a good sense of the need to invest in this country understand that there is a point beyond which it makes sense for this country. If the major enterprise in America is to scavenge for under-valued assets and break them up and sell them, it seems to me that that energy is wasted with respect to our ability to compete in the long term.

I do not deny at all what you have said about the fact that there is some fat in American corporations. I would be the last person on the Ways and Means Committee to say that I want to stand here and defend corporate America. I do not give a rip about corporate America. Let them stand on their own. Let them make it on their own.

But I do not believe that this enormous bubble of speculation that is unprecedented in this country's history can be described as healthy. Much of it is hostile—not much of it, a substantial portion, however, is hostile takeovers fueled by the ability to initiate debt instruments, junk bonds. We did not see this wave of hostile takeovers in the 1960's. We saw a different phenomenon then. That was the growth of conglomerates and synergistic corporations.

Mr. GIBBONS. And that turned out to be a good idea sometimes, but a lousy idea the rest of the time. I knew a lot of businesses that acquired businesses that they did not know anything about. They did it because it sounded good in the locker room of the golf club. I just bought a steel company, I had a fellow tell me, looking out the airplane window. He did not buy a steel company, he bought a museum. He thought he had a steel company.

Mr. DORGAN. But even then it is like comparing a dwarf to a giant. What happened back then is relatively small potatoes compared to the level of what is happening today in this country. I appreciate the visit, Mr. Chairman.

Mr. STOLBERG. Could I add something on this issue?

Mr. GIBBONS. Yes, sir.

Mr. STOLBERG. It always looks worse at the top. We are having important, serious speculations. But if you go back a little bit, part of the boom and part of the reason was the fact that replacement values, if you go back 10 years or whatever, replacement values of companies were dramatically below the public market valuations. Part of the reason is because you have got all these Wall Street analysts running around looking at earnings per share; one little tiny number that the accountants calculate that, quite frankly, is meaningless in terms of how a company is run and how it is valued and whatnot.

So they were focusing on earnings per share. You had all these conglomerates that did not know what they were doing. Stock values were below the replacement values. Companies, the parts were worth more than the whole. You had a few lousy managers. You had some boards that were not paying attention. Stockholders vote with their feet; they sell the stock. That inefficiency created the boom.

I do not know if it was debt. I think it is the economics that created the boom. We are at the point now where prices are up. It is not quite working like it used to. I think Greenspan has done a good job of jawboning the banks. My anecdotal evidence suggests that the banks are pulling in. These hearings have been useful, I think, for putting some sanity into it. I do not know, I think the jig is up. I think the market is going to do your work for you.

Mr. **Gibbons**. We are much smarter than the markets, because if we do not like the rules, the way we come out, we invent some new ones.

Mr. Chairman, have you got some comments you would like to make?

Chairman **Rostenkowski**. How do you account—any one of you—how do you account for what the director of the National Science Foundation said this morning that because of mergers, a decline in research and development is evidenced there? We are all concerned here, or at least this committee constantly gets suggestions that we should distribute more tax breaks for research and development. Yet when you get the big money men trading, research and development is the last thing they do.

Now if you are going to have ongoing success in investing any moneys, you have to be concerned about the future. But according to the Foundation, research and development is the last thing that they are considering.

Mr. **Shaked**. There is a problem to measure much of R&D in many of the leveraged buyouts. Most LBO's are, with few exceptions, in the low technology business. Not too many people like to borrow 90 percent of the transaction and buy out a high technology business. So R&D is a very skewed kind of distribution.

We looked at many of them. The problem is to get, first of all, information for businesses that went private. I do not think that the National Science Foundation has the information because these firms are now private. Their analysis is based on 8 companies. Even in their research framework, you need at least 30 companies—or 40 or 50 or some reasonable number, but not 8—to say that R&D declined.

If you take a look at the R&D in businesses like Tom Lee's that was earlier on the panel, and we wrote a few case analyses like Professor Scherer, R&D goes up. So I do not know where the National Science Foundation gets its eight companies. But that is probably a very limited sample. I would not make too many real conclusions based on his statement with respect to the National Science Foundation.

Chairman **Rostenkowski**. Mr. Scherer.

Mr. **Scherer**. Several points on this. First of all, we did a series of case studies, and we found that under the very heavy pressure of debt service, some of our case study subjects, after going private, did cut back their R&D to some extent. Most of them did not want to, and they expected eventually to go back to a higher level, but the pressure of debt service did force some cutbacks.

Second, I believe that the NSF sample was a little bit larger than that. It included not only some of the classic LBO-type companies, but also some companies—I assume Corning was one of them—that had a voluntary leveraged restructuring.

I know for a fact that Corning, which probably was the world's leader in basic research on glass technology, after its restructuring did change the emphasis of its R&D programs substantially. It continued to do the short-run-oriented projects. But my understanding is it cut back fairly substantially on its longer term R&D.

I do not know what the consequences of that will be for the United States. But some of those long-term projects may get the ax under the pressure of debt service.

The third point is that there are undoubtedly bad R&D projects, those that ought to be cut. Some of those probably have got the ax after restructurings took place and the new management took a hard look at the situation.

Mr. RICE. Mr. Chairman, we have taken a look at the businesses that we have invested in and there isn't any basis that we can find that would lead us to conclude that R&D is a victim of the buyout process. As best we can tell—and this is a statistical summary of 14 businesses—R&D is unaffected by the process.

I think it is also important to note what the gentleman from the Science Foundation did not say. He lumped together the 16 mergers with the 8 buyouts. If you have a merger where you are combining two businesses and both are in R&D, the chances are that you have duplicating projects, and, not all of those projects will be continued. So in the nature of that kind of a combination I think you are going to get a reduction in R&D.

It would be interesting for the committee, I think, to ask him to separate the 16 mergers from the 8 buyouts, and to see if as he got a little bit more deeply into his analysis he did not find that the R&D expenditures went forward as they had in the past. I would suspect that that is what he would find.

Chairman ROSTENKOWSKI. Thank you.

Mr. GIBBONS. Thank you. Any more questions?

[No response.]

Mr. GIBBONS. Thank you gentlemen. This concludes the hearing until 10 tomorrow morning.

[Whereupon, at 1:09 p.m., the hearing was adjourned, to reconvene at noon, Wednesday, March 15, 1989.]

TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS

WEDNESDAY, MARCH 15, 1989

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to notice, at 12:12 p.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. The committee will come to order. Mr. Hickman, Ms. Needham, Mr. Courtney, Mr. Kelso, and Mr. Gates. Welcome to the committee. You are all aware, I am sure, of the procedure here. We ask that you make your statement, and at the conclusion of the statement we will be glad to engage in a colloquy with you.

If you have a statement that is longer than the time allocated, we would appreciate it if you would enter it. Your entire statement will be entered in the record. If you feel that you would like to summarize, please be comfortable in doing that.

It is always a pleasure to see a friend of mine, a former member of this operation, Fred Hickman from Chicago. Nice to see you here, Fred. If you will start off, Mr. Hickman, the committee is ready to receive your testimony.

STATEMENT OF FREDERIC W. HICKMAN, ESQ., HOPKINS & SUTTER, CHICAGO, IL, AND FORMER ASSISTANT SECRETARY OF THE TREASURY

Mr. Hickman. Thank you, it is nice to be back.

The testimony of earlier witnesses in these hearings suggests that there is a near consensus that the existing corporate tax system is not the principal cause of the wave of leveraged buyouts and restructurings that we have seen, but that it is a significant part of the arithmetic. Most of the witnesses who recommend a change seem to feel that to the extent that there is a problem it arises out of the differing tax treatment of debt financing and equity financing, and that if it is to be fixed the ideal change would be to "integrate," so to speak, the corporate and individual income tax systems.

Debt financing is, if you will, a form of self-help integration. It is not complete and it is not perfect, but it does have the effect of subjecting that part of the corporate source income which flows out in the form of interest to only a single tax.

This subject generally, the subject of integration and the difference between debt and equity financing, was studied extensively by the Treasury Department and the Joint Committee in the early and mid-1970's in a project that Dr. Woodworth and I, as Assistant Secretary had commenced at that time. There was, I think, almost total bipartisan support for the proposition that some kind of system of integration would be desirable, if in fact we could afford to get there. You may remember that by the time of the 1976 Presidential election both Presidential candidates in the course of the campaign endorsed the idea.

Notwithstanding that endorsement, the proposal ultimately failed because of two things: Because of a lack of enthusiasm on the part of the business community and because of a series of technical problems on which there turned out to be intractable differences. Those aspects included the handling of the investment tax credit and the foreign tax credit and the handling of dividends that were paid to exempt institutions in the United States and to foreigners who were not in the United States.

Most of those technical problems, with the exception of the investment credit, are still with us. So if one were to look towards integration again, you would still have to deal with those problems and proposals might founder on them.

But the circumstances underlying the lack of enthusiasm of the business community have considerably changed. The lack of enthusiasm at that time was attributable to the fact that integration would, in general, tend to pressure corporate managements to pay out earnings rather than retain them. Today the takeover movement imposes a much greater pressure to pay out than integration ever would have imposed. Corporate managements today are finding that if they do not pay out themselves, potential acquirers may do it for them. So I would predict that the business community today would be much more supportive of integration proposals than it previously was.

One of the things that we studied at length in 1974 and 1975 was whether or not the double tax was a real burden. The two-tier tax is a legal reality, but the conclusion that we came to was that the "doubleness" of the tax, so to speak, was in large degree, mythical. In 1975 the top individual rate on investment income was 70 percent and the top corporate rate was 48 percent. So compared to paying tax immediately, but only once, at 70 percent, a 70 percent taxpayer might be better off if earnings were accumulated in the corporation at 48 percent for an extended period, even if he ultimately had to pay a second tax at 70 percent when they were distributed.

At the same time, the second tier tax was not collected at all if the shareholder died and the value of the undistributed earnings was built into the value of the stock. Then there was the so-called *General Utilities* rule, which excused the first tier tax under certain circumstances; and there was the fact that by selling their stock, stockholders could realize the value of retained earnings with capital gains treatment.

It is ironic that notwithstanding the 1976 bipartisan consensus that integration was desirable, subsequent legislation has moved in the opposite direction, as my written statement explains.

Today we are seeing debt financing in increasing amounts. It is a form of self-help integration. It was foreseeable and foreseen that as Congress tightened the noose on the two-tier tax system in the last couple of years—so that the "doubleness" that was in 1975 largely a myth has become a reality with a vengeance today—that we would have a great deal more debt financing than we previously had. That may have contributed to the current wave of activity, but it was not the cause because the acquisition and mergers takeover phenomenon preceded those changes.

There have been a number of suggestions that deal with the possible disallowance of corporate interest deductions. My written statement addresses that, and suggests that that would be compounding existing defects—moving in the wrong direction rather than the correct direction. Furthermore, the kinds of transition problems that disallowance would create would be very major, and in order to avoid the dislocations that such a change would bring about, one would need to make the change in such a gradual way that it would not have any visible effect on the takeover movement that is bothering people at the moment.

[The statement of Mr. Hickman follows:]

Statement of Frederic W. Hickman

Partner, Hopkins & Sutter
Chicago, Illinois
Before the Committee on Ways & Means
March 15, 1989

I was, as some members of the Committee will remember, the Assistant Secretary of the Treasury for Tax Policy during the early 1970's. The current hearings on the tax policy aspects of mergers and acquisitions have re-focused attention on policy issues on which the Treasury spent a great deal of time in those earlier years. It is old news, I suppose, that there is very little really new news in the area of taxation.

It may be helpful to the Committee to review a little of that history insofar as it seems relevant to today's scene.

The testimony of earlier witnesses in these hearings suggests a near consensus that the tax system is not the principal cause of the recent wave of leveraged buyouts and corporate restructurings, but that it is a significant part of the arithmetic. The transactions in question have almost invariably created significant capital gains for shareholders at the front end, to be followed by corporate tax reductions later on, as the higher debt levels subject a potentially lesser amount of corporate source income to a double tax and a potentially larger amount to a single-tier tax. Whether the tax system is helping fuel these transactions and whether these transactions threaten the revenue thus depends on the interaction of these effects, and the revenue effect to the Treasury depends on whether the front end revenue gains are greater or lesser than the back end revenue reductions. It is only the net difference that counts for revenue purposes.

"Integration" of Corporate and Individual Income Taxes: Old Proposals in a New Environment.

Most of the witnesses who recommended changes in the corporate income tax system seem to feel that the ideal change would be to "integrate" the corporate and individual income tax systems, i.e., to meld the two tiers with credits or deductions in such a way that income earned in a corporation would (with some exceptions) ultimately be taxed only once, at the rates applicable to the corporation's individual shareholders. To the extent that corporate source income is presently chanelled to creditors through interest payments, that integration occurs today in a manner that is both immediate and simple. In that sense, debt finance may be viewed as a form of "self-help integration". Integrating the residual corporate source income that goes to the equity holders, however, is a much more complicated matter.

In 1974, following a series of informal discussions between myself, as Assistant Secretary for Tax Policy, and Dr. Laurence Woodworth, then the Chief of Staff of the Joint Committee, it was agreed that the staffs of the Joint Committee and the Treasury would undertake to study in depth the possibility of implementing an integrated income tax system. Both of us were agreed that if it could be done, and if we could afford it, it would be a very desirable thing. We were mindful, in that connection, that a number of other major countries were moving towards integration. But quite beyond that practical pressure, tax economists had been largely in agreement for a number of years that the two-tier system of corporate taxation distorted the allocation of resources and was generally undesirable. Not the least of the objections to the two-tier system was that no one was, or is, quite sure who bears that extra tax burden. At the same time, however, serious analysts generally concurred that in moving to any such fundamentally new system, the transition itself would produce "unfairness" and new distortions. Thus, a critical issue to be considered was whether the new distortions in a transition period would outweigh the distortions in the current system, with which the economy had learned to live over a long period of time.

Fundamental issues of this sort not infrequently become politicized, which ordinarily dooms their prospects of being enacted. Dr. Woodworth and I agreed that it was very important to do everything possible to keep the question from becoming politicized and in that we were spectacularly successful.

The fact that the study was going on was no secret, but it was little publicized. It was formally announced to the world in testimony by Secretary William Simon before this Committee in the summer of 1975, not as a proposal but as an ongoing study. The bipartisan nature of the project proceeded to the point that in the 1976 Presidential elections both candidates, President Ford and President Carter, endorsed the concept. Dr. Woodworth moved to the Treasury to become Assistant Secretary under the Carter administration and continued to pursue the project.

Ultimately, however, the proposal died. It is accepted wisdom today that it died because of lack of interest, if not outright hostility, on the part of the business community. There is much truth in that, but not the whole truth, I think.

It was true that the then existing two-tier system imposed a substantial tax penalty on paying corporate earnings out to shareholders, whether as dividends or redemptions, and that removing that penalty would place greater pressure on corporate managements to pay out earnings rather than retain them. The prospect of that pressure was not universally popular among corporate managements. Retained earnings were the foundation on which corporate empires were enlarged. During those years, as in prior years, many corporations were engaged in looking for acquisitions to utilize the retained earnings which the tax system more or less forced them to retain. Whether or not that state of affairs prevented enactment, I cannot say, but I think I can say that the proposals did not secure the warm endorsement from the business community for which Dr. Woodworth and I had originally hoped.

There was, however, another significant factor contributing to the demise of the proposal: differences of opinion with respect to some key technical aspects turned out to be intractable. Those aspects included the handling of the investment tax credit, the foreign tax credit and the dividends paid to charities, pension funds and other exempt holders in the U.S. and to foreigners. The investment tax credit is now gone but the foreign tax credit, the exempt institutions and the foreign holders are still with us. New proposals with respect to integration could easily founder again on those problems.

The attitude of the business community, on the other hand, is doubtless much changed. The corporate takeover movement, which many existing managements abhor, is heavily fueled by the existence in target corporations of retained earnings which the acquiring corporations use to finance their tender offers. The net economic effect is that acquirers often seize control by paying the targets' previously retained earnings to the targets' shareholders, in the form of purchase price for the shares tendered. Many of the self-restructurings which we have witnessed in the last few years consist, essentially, of existing managements making redemption payouts to their own shareholders in order to avoid being attractive targets for potential acquirers who would use the same funds to finance a takeover. The pressure to pay out exerted by the threat of takeover is doubtless much greater than the pressure to pay out which would be exerted by an integrated corporate tax system. So long as takeover threats continue, corporate managements are unlikely to worry about the much milder pressures to pay out that integration would produce. In fact, integration might facilitate the self-restructurings that managements undertake to pre-empt the takeover threat.

When we were considering the pros and cons of integration in 1975 and weighing whether the distortions created by the existence of the two-tier corporate tax were greater than the distortions that any transition to integration would entail, a fundamental question was whether the burden of the two-tier system was more apparent than real. In candor, I have to say to you that while the two-tier system is a legal reality, in the 1970's the conclusion that it led to a double tax burden was in substantial degree a myth.

You should recall that in 1975 the top individual rate on investment income was 70% and the top corporate rate was 48%. Compared to paying tax immediately, but only once, at 70%, a 70% taxpayer might be better off if earnings in the corporation accumulated at 46% for an extended period, even if he ultimately had to pay 70% tax on their distribution. That is the same kind of deferral benefit that an employee has under a qualified pension plan—ultimately the payouts are taxable but the earnings of the plan are accumulating at a zero tax rate in the interim. And often the second tier tax was not collected at all (as when the stockholder died and the value of the retained earnings was built in to the basis of his stock) or at a preferential capital gains rate (as when the shareholder sold the stock at an appreciated price that reflected the retained earnings). Often, too, the first-tier tax was avoided with respect to unrealized appreciation by virtue of the so-called General Utilities rule.

In summary, under the two-tier system as it existed in 1975, the first-tier tax was imposed at a lesser rate than the second-tier tax on dividends to top bracket taxpayers; the second-tier tax could be deferred indefinitely and could often be avoided entirely or realized at a preferential rate; and in some instances, the first-tier tax could be avoided and only the second-tier tax paid, often at a preferential capital gains rate. Thus, the existence of a corporate rate less than the top individual rate, the existence of a preferential capital gains rate, the existence of step up in basis at death and the existence of the General Utilities rule all combined to make the so-called "double tax" in large degree illusory rather than real. Nonetheless, we proceeded on the assumption that the extra burden imposed by the two-tier system, while less than double was substantial, and that, in any event, the network of cross effects required in order to avoid the double tax was itself undesirable and distorting.

It is ironic that while there was near consensus on the desirability of integration in 1976, in the years since then Congress has moved in exactly the opposite direction.

In the last few years, Congress has "tightened the noose" on the two-tier tax system. The system now imposes a two level burden with a vengeance. The rate relationships have been inverted, so that the first-tier corporate level tax alone is imposed at a higher rate than the second tier tax ever will be. The ability to lessen the second tier tax by paying it at a preferential capital gains rate has been eliminated. The potential of avoiding the first-tier tax by using the General Utilities rule no longer exists. Step-up in basis at death still exists, but the fact remains that even the first level tax is imposed at a discriminatory rate. Thus, whatever the degree of discrimination imposed by the two-tier system may have been in 1975, it is enormously greater today.* The corollary is that eliminating it today would be relatively more costly to Treasury revenues than it would have been fifteen years ago.

Debt As "Self-Help Integration"

Substituting debt for equity is, of course, a species of "self-help integration". The return on investment in corporate assets which comes in the form of interest is removed by deduction from the corporate level tax base, which is taxed at 34%, and rechanneled to the creditor's tax base, which is subject to a top rate never higher than 34% and usually lower. The tightening of the two-tier noose in 1986 and 1987 inevitably encouraged that kind of self-help integration. Whether and to what extent that kind of behavioral change was reflected in the earlier revenue estimates is unclear to the public and is, in any event, water over the dam. It was, however, easily forseeable and, in fact, foreseen. It may have added some fuel to the takeover and restructuring flames, but it did not light those fires, as they had been burning for several years.

There are today, as there were in 1975, suggestions that the corporate interest deduction should be partially eliminated in order to treat corporate debt and corporate equity more equally. Such proposals are sometimes described in terms of lessening the "tax advantage" accorded to debt. But that is a misleading way to describe it. It is more realistic to view it as evening up the "tax disadvantages"—imposing a new tax penalty on corporate debt to correspond to existing tax penalties on corporate equity. Interest disallowance proposals are not new suggestions. They were around fifteen years ago, too. I recollect at least one occasion on which the suggestion was advanced by Arthur Burns, then chairman of the Federal Reserve Board, and Treasury was successful in convincing him of its non-wisdom.

Disallowing a portion of the corporate interest deduction would be moving in the wrong direction. It would simply be increasing still further the penalty on corporate source income, a penalty which has already been considerably increased by the 1986 and 1987 legislation. Here, as in most cases, two wrongs would not make a right.

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*An excellent and detailed analysis of this transformation may be found in B.L. Ferguson, "Corporate Restructuring and Transfers after the Tax Reform Act of 1986 and the Revenue Act of 1987," National Tax Association-TIA Proceedings, 1988.

Once a major discrimination like the two-tier tax on corporate equity is introduced, trying to even it up by imposing penalties elsewhere only gerrymanders the boundaries of discrimination. If the corporate interest deduction is disallowed, the discrimination between corporate source income and non-corporate source income becomes even greater than it already is. And if we were to disallow the deduction for all interest—both corporate and non-corporate—we would be imposing, to that extent, a new double tax on non-corporate investment income.

Furthermore, any disallowance of the corporate interest deduction would create very major transition problems. If applied to presently outstanding debt it would render existing debt levels unsustainable for many companies. It is true that taxpayers must expect the world, including taxes, to change and some would say that if such a disallowance turned profitable companies into loss companies and drove other companies into bankruptcy, so be it. But is is also true that radical changes that produce that kind of result on a large scale endanger the health of the entire economy and are counter-productive.

On the other hand if only interest on "new" debt were disallowed and all outstanding indebtedness were grandfathered, new companies and expanding companies would be placed at a major competitive disadvantage. In dealing with debt we are dealing with a very large and fundamental component of investment income and major changes are bound to produce major dislocations. Doubtless some transition could be managed without unduly adverse side effects over some considerable length of time. But the fact remains that we would still be moving in the wrong direction and in order to avoid the problems of dislocation it would be necessary to move so gradually that the change would have very little effect on the acquisitions and restructurings which seem to be bothering many observers at the moment.

I should like finally to comment on one revenue aspect of any shift to debt financing which seems to be widely misunderstood by practicing tax professionals.

It is not yet clear that, judged by historical standards, there has been a major shift from corporate equity to corporate debt. But if it should occur, a number of tax professionals have concluded with alarm that corporate income will to that extent escape taxation almost entirely, because so large a part of the indebtedness outstanding is held by entities that are exempt, like charities and pension funds, or that are not effectively subject to tax, like foreigners. The concern alleged is that investment income will drop in wholesale quantities into some great black hole, never to be taxed at all. That is not the case. If there is a major conversion of equity to debt there will be some revenue loss from that fact because of the effects explained earlier (offset at least in part by tax on capital gains incurred to effect the conversion). But if charities and pension funds purchase new debt they will have to forego holding some other investment. Income is exempt on whatever they own. Only if a conversion from equity to debt causes exempt entities to become more profitable i.e., to earn more investment income, either in the form of dividends, interest or capital gains, is there a "black hole". That seems unlikely to occur, at least to any significant degree.

The proper way to analyze the revenue effect is to assume that the first tier tax will be eliminated to the extent that equity is converted to debt and the second-tier tax will, in the absence of evidence to the contrary, be taxed in proportion to the varying rates of all owners of investment income, exempt owners and taxable owners alike. The situation with respect to foreigners is somewhat more complicated, because those entities are free to expand their portion of total investment income in response to changes in tax consequences. But again, there is no reason to suppose that this particular change would cause them to do so.

Mr. Coyne [presiding]. Thank you, Mr. Hickman.
Dr. Needham.

STATEMENT OF NANCY J. NEEDHAM, INDUSTRY PROFESSOR OF MANAGEMENT, POLYTECHNIC UNIVERSITY, NEW YORK, NY

Ms. Needham. Mr. Chairman, members, thank you for inviting me.

I am not against LBO's and mergers, per se, but I think it is critical that we distinguish between good LBO's and bad LBO's. That you cannot tell from press releases based on earnings. Bad LBO's have junked up balance sheets; they are loaded with financing gimmicks; money is borrowed simply to change control but not to grow assets; and they have too much risk. They borrow beyond their means; their revenue gets chewed up in meeting interest costs. One case we studied, ACF—a company LBO'd by Carl Icahn—now has 70 to 80 percent of its revenues going to pay interest.

When LBO's fail, real people get hurt and real consumers pay a price. There is an LBO cable company right in your home State, Mr. Ford, which is now trying to raise its prices in order to cover its interest costs.

Having bad LBO's awash in debt means that we cannot really compete well. It basically weakens our overall corporate infrastructure.

The problem is that the incentives to do these deals, both good and bad, are very, very enticing. Our research on banks shows that 60 percent of LBO financing comes from banks. Banks, in effect, provide four times the financing that junk bonds do, yet most of the attention is being paid to junk bonds. The estimates of total bank financing vary from a low of about $150 to maybe $250 billion. But that is roughly equivalent to half of commercial banks' equity.

The S&L's that you heard about this morning have taken syndicated pieces of some of those LBO deals. The syndicators and the packagers take the rewards early. Other people bear the risks later. Banks, remember, are loaning federally insured funds. Like the debtor countries that Secretary Brady talked about this morning, bad LBO's cannot service their debt. So I would suggest that bankers could end up bellying up to quite a few more bars than just the LDC bar mentioned earlier this morning.

Secretary Brady referred to a 10-minute horizon for stocks and stock churning. An important element of that churning is the allowance of margining 13-D stock to buy control. In one case a loan out to a broker was for $460 million for one block of a takeover stock.

All of the focus and all of the media attention and all of the hype has been on the short term. But there is a serious need to do something now, because longer term, that debt is going to catch up with us. I have several recommendations.

The first is that you eliminate the deductibility of interest on all debt which is above a 4 to 1 debt-equity ratio. This really goes to the heart of the matter and treats this debt like what it really is, equity under another name. This measure would also go after these very, very highly leveraged deals. We are seeing LBO's now that have debt to equity ratios of 8 to 1, 9 to 1, and in some cases no equity at all.

Second, you could disallow the interest on deductions for rates over a stated percentage above the Federal Reserve discount rate. Both these concepts could include small business exemptions. But we really should not have tax incentives that reward financial buccaneers who are willing to go way out on a financial limb.

The third recommendation is that you limit use of borrowings to buy stock before a tender. That is, do not allow margining of 13-D stock. Where this committee would come in on the tax angle is you would disallow deductions of interest on all 13-D stock loans.

Finally, we need to have much better data as well as time in order to analyze whether a proposed LBO is good or bad, and certainly better disclosure to the SEC will help. But I urge you to recognize now that based on debt levels and the ability to service debt, distinctions can and should be made between good and bad LBO's.

Thank you.

[The statement of Ms. Needham follows:]

Incentives and Financing Mechanisms for LBOs and the Possible Actions Government Can Take to Address Them; Remarks by Dr. Nancy J. Needham, Industry Professor of Management, Polytechnic University before the House Committee on Ways and Means March 15, 1989.

Mr. Chairman and Members of the Committee:

Thank you for inviting me to participate in the continuing hearings on the tax policy aspects of mergers and acquisitions.

In a recent address, Judge Stanley Sporkin noted that "MBOs and LBOs have certainly traumatized our financial and securities markets."1/ I would add that they raise profound questions about the shape and character of our nation's corporate infrastructure. This Committee has heard much conflicting testimony about the effects of leveraged buyouts and other forms of mergers and acquisitions. It is not surprising that there is disagreement about issues that have been couched in such broad and general terms. There have also been some suggestions that Congress should not substitute its judgment for that of the marketplace. However, the Congress has already intervened in the marketplace by establishing deductibility of interest on corporate debt coupled with the double taxation of dividends, and by enacting securities, banking, and pension measures.

The debate should not be whether LBOs and mergers are good or bad. There are good ones and bad ones. Nor should it be whether government action is appropriate. It is. But in order to determine what government actions can be taken that will improve the situation rather than exacerbate it, several key questions need to be examined:

1. How can a bad LBO be distinguished from a good LBO? And what are the major public policy concerns about bad LBOs?

2. Having defined one, what are the incentives to supply funding to LBOs, both good and bad, and for buying their paper?

3. What are the financing mechanisms and techniques used? And is there accurate and adequate disclosure about individual deals so that investors can act to protect themselves and creditors can make sound credit decisions?2/

4. What are the remedies which might be applied? Can the government remove incentives and/or adopt disincentives to discourage bad LBOs?

Distinguishing a Good LBO from a Bad LBO

A "good" LBO is one structured and operated by managers committed to the business for the long term and prepared to earn their profits through operating the business more efficiently and effectively. The Oregon retailer, Fred Meyers, has been considered an example of a "good" LBO having made capital investments, expanded its operations and increased its hiring. This approach is diametrically opposed to that used by financial speculators who see the business either as a springboard for financial manipulations and/or a collection of assets to be sold off for immediate gain.

1/ Stanley Sporkin, U.S. Financial and Securities Markets Under Stress--Some Thoughts for Reform. Address Delivered at The Colloquium on Corporate Law and Social Policy, The University of Toledo College of Law, March 6, 1989.

2/ The current S&L crisis is generating a good deal of comment on how "somebody" should have recognized the problems and reacted with an appropriate regulatory response to control the behavior of those who recklessly used other people's money. It seems apparent that creditors and investors need sufficient disclosure about LBOs and acquisitions that they can recognize the problem deals before they are completed. And sufficient disclosure does not mean more paper, it means better and more realistic information and sufficient time to analyze it.

In a bad LBO, management's efforts are directed at devising financial gimmicks and amassing short term gain. Those who formerly relished the title, "corporate raider", are now employing public relations firms to cast them in the light of managerial geniuses. Thus LBOs cannot be deemed "good" based on claims managerial competence.

The key determinant of a bad LBO lies in the level of risk taken on in the transaction. The measure of this risk is found in basic principles of finance. A "bad" LBO is one that has an unacceptably high level of debt relative to the company's ability to cover it -- both in good times and in bad. And even smart people either do not, or will not, take a hard enough look at whether or not a deal can support the debt being taken on. For example, one of the first really large LBOs closed in September, 1986 when a young company, Patrick Media, bought out what had been John Kluge's billboard empire. In this friendly acquisition, $800 million in loans was provided by a quite respectable cast of characters in a deal packaged by Paine Webber and supported by such well-known companies as Aetna and Teachers. Today that once-acclaimed piece of investment banking prowess is recognized as a deal gone awry because of far too much debt which the company simply cannot service.

Who will get stiffed? The lenders at first glance. But this assumes that lenders are risking their own money. Ultimately those who suffer are the customers of the companies that make poor investments, the people who contribute to savings accounts or invest in mutual funds that are used to buy LBO paper and, perhaps even pensioners like those teachers whose pension fund made the Patrick Media investment.

It is interesting that in recent testimony which, basically, asserted that LBOs were a positive phenomenon, Professor Michael Jensen of the Harvard Business School made the very telling comment that ,"...buyout firm's [sic] systematically underperform the post-buyout projections made in the proxy materials provided to the selling shareholders."[3] Systematic underperformance after the fact implies systematic over-optimism in the LBO projections. And he also noted that "LBOs get in trouble frequently, but seldom enter formal bankruptcy. They are reorganized...often under new management. ..."[4] But even the best manager in the world cannot turn straw into gold; if there's too much debt, it cannot be paid off.

As an example of the sort of financial maneuvering that results from assuming high-risk debt to gain control, let us look at Carl Icahn and what he has done to and with one of his first acquisitions, ACF. He has been able to have ACF borrow almost $1.2 billion against $780 million of operating plant and equipment. He has used this borrowing power to buy all of TWA, almost 20% of Texaco and 10% of USX. He took an operating company and turned it into a vote buying platform where 80% of operating revenues go to cover interest costs. This does not seem to have hurt Icahn's reputation, nor impaired his ability to borrow more money despite the fact that ACF's bonds have technically been in default several times in the past few years.

Public Policy Concerns About Bad LBOs

Bad LBOs become a matter of public policy concern because overly leveraged companies cannot compete effectively in global markets, much less domestic markets. This hurts workers and consumers. Put simply, a bad merger or LBO is one where a very few people get very rich while a lot of other people get ripped off and our overall corporate infrastructure is weakened.

Financial speculators today establish multiple corporations with interlocking relationships and investors. They resemble a combination of the old holding companies and investment trusts that caused so much havoc in the Twenties. Such vehicles could provide a way for both unidentified foreign investors to take over key industry segments, albeit indirectly, and perhaps even for laundering of drug and other criminally generated money. So it is important that we get better, not necessarily more, data disclosed to the SEC about the companies and individuals involved in this restructuring of our corporations.

3/ Michael C. Jensen, The Effects of LBOs and Corporate Debt on the Economy: REmarks Before the House Subcommittee on Telecommunications and Finance, February 22, 1988. p. 8

4/ Ibid., p.7.

A constructive insight that should guide this Committee in developing an appropriate public policy response is suggested in an earlier article by Professor Jensen which noted the obviously self-serving nature of overly-leveraged companies: "We don't find many large firms financed almost entirely with debt type claims because of the effect such a financial structure would have on the owner-manager's behavior. ... With that financial structure the owner-manager will have a strong incentive to engage in activities (investments) which promise very high payoffs if successful even if they have a very low probability of success. If they turn out well, he captures most of the gains, if they turn out badly, the creditors bear most of the costs."[5]

Who gets hurt if an LBO deal goes sour? The banks--but,if they're insured by the federal government, it is the taxpayer. The bondholders who lent in good faith before the buccaneer arrived on the scene. And if the situation cannot be salvaged, the people who worked at the company. It is fashionable to talk about "bloated" companies, "fat" staffs, redundant people--but everyone who is fired because of an LBO either has to get hired by another company, collect a pension, or go on the public dole in some form. And if the LBO stays afloat, but is squeezed, its need to raise prices simply adds to inflationary pressures and hurts consumers. For example, a cable television operator that LBOed its company is currently battling to raise prices in its monopoly service area in Tennessee.

A January, 1988 study by the Congressional Research Service noted:

> For every anecdote describing the efficiency of a leveraged buyout restructuring, there appears to be a case in which large-scale layoffs have occurred and research and development budgets reduced under the weight of debt.[6]

The LBO of Safeway, headquartered in Dallas, resulted in layoffs of 9,000 employees. This was so disruptive that some employees were reportedly driven to suicide and Bill Adler who covered the story described it as a "nightmare" involving "real people that Wall Street didn't seem to recognize."[7]

Incentives

Why is it that "bad" LBOs are financed? To answer this question we need to look at the incentives to the parties in the deal. The sellers are the current stockholders and they are usually offered a clear profit now. That's what makes the deals work. The buyers and their investment bankers also structure the deal in a way that gives them as much of the profit up front as possible while shifting the long-term risk to someone else.

Those who currently benefit from LBOs include some very powerful groups: commercial banks, investment bankers, lawyers and a small group of excessively rewarded raiders and management insiders. Not only do they have no incentives to change their behavior, they bear little risk if things go wrong. And they will go wrong.

Then why should lenders take these risks? The junk bond dealers who have argued that LBOs create jobs are not the people who are fired if the deal goes sour. They have already gotten their multi-million dollar fees. The investment bankers package the deals to collect their fees at the beginning -- fees which are high enough that 28 year olds can buy a ski house and a Porsche with one bonus. The investment firms that write fairness opinions about the deals get their fees up front too. There is little incentive to separate good LBOs from bad ones.

The recent example of Beatrice Food illustrates how well the investment bankers take care of themselves. Beatrice reported a $105 million operating loss and debt of $2.9 billion, but KKR, according to The Wall Street Journal was, "considering a quick fix [for investors]; Beatrice...would borrow more money, or drain Beatrice's cash supply in order to pay investors a one-time dividend of as much as $800 million."[8] And KKR made $45 million in initial advisory fees, while Donald Kelly who came in as president got $6.8 million in advisory fees plus another $13 million in addition to an annual salary of over $1 million.

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[5] Jensen, C. J. and W. H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, Journal of Financial Economics 3 (1976) 305-360. Emphasis added.

[6] Reported in The New York Times, January 31, 1988

[7] Conversation of William Adler with Linda Kesslar, financial journalist, March 13, 1989.

And then there are the buyers of junk bonds. Who are they? Their ranks include life insurance companies who need higher-than-normal returns so they can sell annuities in competition with other financial institutions' products. Buyers include S&Ls--the last group that needs to add more risk to their battered portfolios. Buyers include mutual funds that want to show high returns, but whose shareholders may not really understand that the term "high yield" means "junk bonds." And for both junk bonds and junk loans there are insurance companies seeking to invest the constant stream of premiums that come from policy holders.

Finally, there are pension fund managers who compete for the fund management job with other managers and want, therefore, to demonstrate they can earn a better return. Each of these groups has an incentive to try to get the highest short-term return. Because the return is immediate and the risk is farther out, the people who make the decision to buy junk will look good in the short-term and probably will not even be there in five years to take the blame if things go wrong.

Another incentive is the search for volume. It has always been true that higher risk loans generally come at a higher price--that is, the borrower has to pay more for the money. What is different today is the amount of LBO debt being provided by commercial banks.[9] In 1987 over 136% of all net new commercial bank loans was for mergers and acquisitions, meaning that working capital loans were being rolled over but not fully replaced and that new loans for R&D, capital equipment and other activities designed to generate operating revenues were replaced by loans designed to change ownership and control. During 1988, the ratio of net new merger and acquisition loans to commercial and industrial loans was between 70 and 90%. The total amount loaned went from only three billion dollars as of February 1984 to $115.5 billion as of October 1988 and has probably reached $150 billion by now. And these numbers do not include the monies, often substantial, that foreign banks have loaned to finance LBOs. Since foreign banks are not obliged to report to the U.S. government, we do not really know how much they have lent. And it means the total amount of bank lending is higher than we might think.

There is a large group--the American taxpayer--who will be expected to clean up any future mess just as they have been asked to clean up S&Ls. And the American consumer will face pricing increases on products and services.

Chairman Greenspan, having noted his concerns over the rise in leverage, ended his formal testimony with the comment that "the circumstances associated with highly leveraged deals require that creditors exercise credit judgment with special care. Doing so entails assessing those risks that are firm-specific, as well as those common to all highly leveraged firms."[10]

But where is the evidence that creditors will exhibit this special care in the absence of any incentives to do so? Banks are lending deposited funds that are federally insured, they have syndicated their LBO loans as fast as possible to their unsuspecting and less sophisticated brethren, and they can see that the federal government has agreed to bail out the S&Ls whose credit assessment capabilities have proven dubious at best.

Most importantly, lenders have to lend money to someone. And if their choice is a sensible manager who wants to borrow money to build a plant, but wants to pay a rate close to prime, and a financial adventurer who wants to borrow money to buy stock and will pay five or six points above prime plus a fat fee--it's no surprise that the LBO wins. In short, the credit decision is between a sensible manager at one end of the spectrum and, at the other, a speculator who is willing to climb way out on a financial limb.

One final incentive that has shifted the balance towards debt financing is the deductibility of interest, while corporate dividends are not deductible for the corporation or the individual. The consequence has been that debt has been markedly cheaper than equity as a source of funds. Its use was limited in the past by managerial prudence, and the discipline of a lending market that either rationed lending or charged ever-higher interest rates for debt as a company took on more. The extreme interest rates of the 70's and the development of the junk bond market, coupled with almost a decade without a recession, appear to have desensitized management to the risks involved in high leverage. We now have a generation of managers who no longer remember the financial lessons of the 30's. The apparent cost-free profits from a quick buyout have proven to be irresistible. There appears to be something for nothing in substituting cheap, deductible interest for the stodgy safety of equity...until the downturn.

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[8] The Wall Street Journal, November 21, 1988.

[9] White, D. L. and E. R. du Pont, "The Role of Banks in Merger Financing," forthcoming.

[10] Greenspan, Op.cit.

Financing Mechanisms and Techniques

Use of Debt Versus Equity

Levels of indebtedness are measured by debt-to-equity ratios. My colleagues and I have been researching what is considered "acceptable" in terms of debt to equity ratios. We found that over time U.S. companies have gotten more and more leveraged, but there has been no concomitant agreement on what constitutes an acceptable debt to equity ratio. Federal Reserve Chairman Alan Greenspan testified recently that:

> Aggregate book value debt/equity ratios based on balance sheet for non-financial firms have increased sharply in the 1980s, moving outside their range in recent decades... .[11]

Wall Street is said to be preoccupied with the short term, at the expense of the long. Certainly the focus of far too many in the financial world is on the income statement of a company and not the balance sheet--which is where you find debt to equity ratios. Historically, our utility companies were more leveraged than their non-regulated counterparts. The theory was that utilities could tolerate higher levels of debt because they had a prescribed rate of return and because higher debt levels made their capital "cheaper" because of the interest deduction. And that "high-level" of debt to equity was about one to one.

We have moved from a time when 50% debt was considered as high as you wanted to go--and you better be a regulated utility if you did go that high--to a situation where debt to equity ratios of one to one are commonplace, two to one not unheard of, and for some LBOs, well over eight to one. We even have some transactions which result in companies with no debt to equity ratio because there is no equity! However, as recently as 1986, out of the 1200 largest publicly traded companies listed in Value Line, less than two percent had debt to equity ratios over four to one.

Despite the fascination with short-term earnings, the market knows when a company has gone beyond the pale in terms of its leverage. The RJR deal offers ample evidence of this. When the deal was announced, the value of RJR's bonds fell sharply. The value of RJR bonds in one North Carolina portfolio dropped by $120 million, a drop not offset by the $30 million it gained on its stock. That $90 million loss was not sustained by those immediately involved in the transaction, but by pensioners and others with no control over the company's decision to leverage itself.

Last week the rating agencies formally recognized the drop in value that the market had already priced. The ratings of RJR bonds were lowered. But this is after-the-fact and is of no consolation to those who bought bonds in good faith and now see that faith--and their money--eroded by the LBO decision. Nor does it help much for such bondholders to hear that, overall, equity holders made significant gains.

Debt-to-equity ratios are considered important because they represent a measure of how much debt a company can service and still have sufficient funds to conduct its business and grow. Prior to the LBO phenomenon, large borrowers typically received a "prime" rate of interest because the assumption was that they knew what they were doing, enjoyed economies of scale, and would be able to handle the debt coverage. Today, borrowers may take on vast amounts of debt that has an interest rate far above prime--and a level of risk that seems, generally, to get ignored as LBO deals get touted.

11/ Testimony of Alan Greenspan, Chairman, Federal Reserve Board, before the Senate Finance Committee, January 26, 1989.

But companies whose treasurers want to borrow and use money the old-fashioned way -- by buying plant and equipment -- are penalized by deals like RJR. LBOs have degraded normal corporate debt and make new borrowings more expensive. Lenders now fear that if there is a takeover, there will be a subsequent drop in the value of the corporation's bonds. And these lenders now make corporate debt more expensive for all treasurers, regardless of their connection with LBOs.[12]

In short, the link between the amount of money loaned and ability to pay has been replaced by the borrower's willingness to go out on a financial limb, regardless of the long-term impact on the company's future. But, when all is said and done, we need corporations to make products and supply services that somebody wants to buy--at affordable prices. And companies need capital to do this. Equity serves the purpose of providing capital and giving breathing room for the firm to invest it and realize returns; debt, on the other hand, requires immediate and constant outflows of cash. Good LBOs can handle that outflow and bad ones cannot. Dividends to shareholders are paid if the company has made money; debt must be serviced regardless. This inherently greater risk accounts for the higher interest rates which banks charge for LBO-related debt.

It is pointless to say that LBOs are "better" than the companies they replaced because they show a higher return on equity. Suppose a company has a return of $200 and equity of $1000. If equity is decreased to $100, and debt increased, the interest cost on the debt will drop the return to, say, $100. Despite the fact that earnings are lower, the company is "transformed" from having a return of 20% to a return of 100%! It sounds wonderful. But more to the point, it illustrates the deceptive benefits of increasing the riskiness of a firm. When you go from a conservative debt carrying position to a high risk one, you immediately improve results in the short term.[13] If you reduce debt coverage from four to one down to two to one, you automatically increase return on equity. But you increase risk. This is not sound management, it is financial smoke and mirrors.

Vote Buying

One way to gain control without proving that one has better management is to buy enough votes to win the stockholders election (or tender). Currently a potential raider can buy up to 5% of the stock without disclosing any intent. After that he must file a notice with the SEC (a 13-D filing) showing that he has bought at least 5% of the stock.

He can go on buying, and is allowed to pledge this stock at full market price as collateral for margin loans. This is true, even if the owner is a corporation that has already issued substantial amounts of debt, so long as there is no direct pledge of the stock to support that debt.

The issue of the ability of bidders to purchase votes is one that has much room for improvement. As it is now, a raider can borrow 90% or more of the cost of acquisition of the voting stock and deduct the cost of the interest. Under current disclosure rules, he will have to file a form 13-D (or, under proposed rules, so long as he claims that he does not intend to take control a 13-G) after acquiring 5% of the stock of a company. Thereafter, his actions will be a matter of public record, and investors will be able to reassess the values of their positions in the light of the possibility of a takeover.

By definition, 13-D stock is a significant percentage of the market supply of a firm's equity. If the holder tried to sell it all he would influence the market. Therefore such significant blocks of stock should be held to a separate standard. Today, given the LBO phenomenon, 13-D stock has a significant effect on the market. One often sees a 10-20% market swing on basis of activity by a holder of 13-D stock.

It could be argued that 13-D stock, in effect, allows the holder to "rig" his own market by using the fact of filing as a way to influence prices. If this 13-D stock, moreover,is bought on the basis of a margin loan, there is a risk that the swing can go the other way. If a 13-D margin loan goes, the lending institution can take a real hit.

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[12] Clearly there needs to be some form of insurance for holders of existing corporate bonds.

[13] Debt carrying capacity is defined as the ability to cover interest costs.

It is important for the investing public to learn as quickly and as clearly as possible that a takeover is likely to happen, since there may be a significant change in the price of a stock in the face of a potential takeover offer. For instance, when Carl Icahn began to buy more Texaco last fall, the price rose from $43 to $53 in short order, and when he signed a "standstill agreement" with Texaco in February, it dropped back down.

Furthermore, despite the heavy borrowing by ACF, its affiliates have been able to pledge the full value of the Texaco and USX stock at brokers to borrow yet more money. In one case, a large block of Texaco was pledged against a single $460 million dollar loan at a single broker.

Secrecy and Fast Strikes

The SEC has just issued a proposed set of regulations to deal with the issue of secret corporations. Comments are due in May. The general thrust of the SEC's proposed rules is to ensure that sufficient and appropriate information is disclosed.

Many takeovers or going private transactions are financed not by a cash transaction, but through the issuance of bonds or stock in other entities. However, in order to decide whether to accept or reject an offer, the stockholder must make judgments about the likely real value of any such instruments and the managerial capability of the proposed acquirers to ensure that value will be sustained in the future. But to make such an informed judgment with respect to the financial soundness, managerial ability, and/or fitness of a proposed acquirer of a corporation, the stockholder must have information which is currently not disclosed.

Disclosure is now limited to a single entity and a given transaction and not to other factors which affect the value of the transaction. Many acquiring entities are not public corporations and much information is, therefore, not available to management, stockholders or bondholders of the corporation. Further, even in the case of a public company acting as an acquirer, disclosure is tied only to disclosure of a given entity involved at a given point in time in a given transaction and not of interlocking entities and their history. Thus, merely by creating a new entity, or using a private company, the intent of current public disclosure requirements is being circumvented. The data may exist elsewhere, but if one has to go to State offices, other SEC filings, other government offices for information, the time required to collect data and do the analysis exceeds that allowed under SEC regulations. In one instance, my colleagues and I ended up going through nearly three feet of documents from a variety of state and federal offices in order to unravel the relationships among Carl Icahn's many entities and figure out the finances. Given that Carl Icahn has over 100 corporate entities as well as Panamanian and other foreign investors, it was a time consuming task. Sorting out the maze of Coniston affiliated firms involved in the Gillette takeover attempt was another horrendous task for the reporter who performed the research.

And, finally, the fairness of the "fairness" opinion cannot be assessed from the information disclosed. The "fairness" opinion is intended to provide shareholders with assurance that the offered deal is, indeed, "fair." But fairness is often in the eye of the beholder and the stockholder is not provided with the same data as the provider of the fairness opinion so that he can make his own determination rather than accept an opinion paid for by the proposed buyer. Nor is the analysis and/or reasoning behind the fairness opinion provided to the shareholder. Further, because of the lack of disclosure cited above, the fairness opinion relates solely to the price offered and does not provide help in the area of whether or not the buyer's methods of paying that price are fair, likely to succeed and/or sound. Since disclosure of information and methodologies are not required in advance, the shareholder's only recourse is expensive, time-consuming litigation. Monetary damages awarded well after a transaction has taken place cannot put Humpty Dumpty back together again.

Accountability

What about the people who make ill-conceived decisions about how other people's money is used--fund managers, corporate managers who junk up a balance sheet or lenders who ignore sound credit risk assessment? They must be held accountable for their decisions. The taxpayer should not have to make good, the decision-makers should. The traditional answer is that aggrieved shareholders can sue. But generally suits are aimed at corporations or other organizational entities, rather than those in fiduciary capacity who have made the imprudent decision.

Until there is more meaningful accountability, risk taking and, in certain instances, greed will prevail and the wrong people will be asked to make up the damages.

This then is the situation which confronts Congress: ill-conceived credit decisions are being made by lenders who have every incentive to make risky judgments; companies are getting junked-up balance sheets and jeopardizing our ability to compete internationally much less ensure we have jobs domestically; the Treasury is losing taxes; there is no accountability for ill-conceived risk taking, but there are high rewards; and insufficient quality information, as opposed to quantities of information, is disclosed before deals are consummated.

Recommendations

The following proposals are intended to address the issues cited above:

Eliminate Tax Incentives for Bad LBOs

The L in LBO stands for leverage. Companies whose debt level gets beyond a certain point because of financial speculation should not enjoy the same deductibility of interest as companies who are using funds productively. Sensible managers simply don't want to junk up their balance sheets. Financial buccaneers who will reap instant gain and bear no responsibility for the future couldn't care less if they junk up a balance sheet.

To ensure that tax policy does not encourage the formation of debt-ridden, bankrupt-prone, or to use the euphemism, "workout and restructuring" entities, the committee should consider alternatives which are disincentives to using debt above prudent levels. The alternatives include:

1. Eliminate the deductibility of interest on all debt which is above a four to one debt/equity ratio.[14/] This measure would change the debt coverage requirements and would limit the debt ratio of an LBO because it would require more cash flow for the same level of debt. This requirement would tend to reduce those very highly leveraged deals that are causing the concern in the first place--the bad LBOs. It would not affect good LBOs or mergers. This tax treatment should not apply to financial institutions, which have a different financial structure, nor to real estate which has always been heavily leveraged.

2. Eliminate tax deductibility for high risk debt, which would be defined as debt carrying interest at a stated percentage above the Federal Reserve's discount rate. This would effectively leave to the marketplace the determination as to which deals are too risky to receive favorable tax treatment. An exemption could be provided for small businesses which traditionally pay higher rates. The non-deductibility could be phased in.

Since the issue at hand is how to discourage over-indebtedness as opposed to killing off all LBOs, these approaches would only affect the real mega-deals.

Suppose, for example, an LBO resulted in a debt to equity ratio of six to one. Then interest on only four dollars out of every six of debt, or two thirds of the debt, would qualify for interest deductions. On a large deal where the ratio of debt to equity is nine to one, half the debt would not be subject to interest rate deductions.

In determining debt to equity, debt (defined as all long term debt plus debt due within one year plus short term notes) would be divided by the book value of shareholders common equity. Preferred stock could be excluded from the calculation.

[14/] At that level of indebtedness the debt begins to look more like equity anyway, and the equity-look-alike factor is enhanced by such financial maneuver as paying interest "in kind" rather than in cash. (And some have suggested that it be explicitly declared equity regardless of what investment bankers decide to call it.)

Underlying the theory of stimulating the economy through investment is the concept that economic growth will increase personal earnings, thereby resulting in more taxable income. The concern voiced over eliminating double taxation of dividends is that too much tax revenue would be lost. However, the Committee could phase-in dividend deduction in tandem with a phased-in removal of the interest deduction for very high loan levels.

Although such a suggestion could be denominated a "tax," it is analogous to an excise or "sin" tax, which is avoidable through a change in behavior. This committee worked on tax law changes which held consumers' feet to the fire and limited deductibility of interest for consumers. The same can be done for businesses. Companies that want to invest in productive resources will not be penalized and those that continue to engage in excessive financial speculation will bear a greater portion of the potential costs that their risking behavior imposes on society. And those that continue to speculate, wanting the potentially rich rewards if all goes perfectly, will contribute tax dollars which offset, to some extent, possible losses from the elimination of some part of the double taxation of dividends.

Prohibit Margining of 13-D Stock at the Same Level as Non-13-D Stock

Unfortunately, one thing which can affect the outcome of corporate takeover contests is the willingness of the players to buy votes. In this context "votes" equates to stock.[15/] So Congress must address the question of the financing sources which let a player buy stock.

The LBO concept has made it possible for a person with a high tolerance for risk to borrow almost all the money needed to purchase enough shares to force a victory, whether he has the best technology or not. If he borrows the money via Junk Bonds on an existing corporation, under existing interpretations of margin rules, there is no regulatory limit on the share of the value of the stock that he can borrow. This means that "bad" technology coupled with the willingness to go way out on a financial limb can "win" a company.

Therefore, the use of 13-D stock in a margin account should be limited because of the need to:

> Protect the integrity of markets by limiting the degree of credit risk in order to avoid cumulative defaults during a rapid decline (e.g., we want to cut self-feeding in a decline)
>
> Control excessively speculative activity.

Furthermore, the current practice of buying the stock through affiliates of a highly leveraged companies, and then offering it as collateral in a margin loan should be stopped. The working definition of the amount of margin allowed should take into account the debt from other sources that has already been used. Thus, it seems reasonable to propose that:

> 13-D stock should not be allowed the same 50% margin financing as non-13-D stock. This would inhibit the ability of financial speculators to buy votes with borrowed money, thereby disadvantaging both current management, which might well have the best technology, and existing shareholders who cannot self-rig the market with large 13-D blocks.
>
> Further, the interest on other loans used to purchase 13-D should not be tax deductible.

Meaningful Disclosure

Finally, the SEC's proposed rules for fuller disclosure should be supported and funds should be made available to study what is happening with our corporate infrastructure. In addition to more meaningful disclosure, there should be more time allowed to fully analyze tender offers and other proposals which are, increasingly, of a dizzying complexity.

Earlier disclosure would ensure that holders of "votes" can find out earlier that there may be a contest, and can better determine which group has the

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[15/] See Harris, M. and A. Raviv, Corporate Structure Contests and Capital Structure, Journal of Financial Economics 20 (1988) 55-86.

better "management technology" for the company. This is especially true for managers of pension funds subject to ERISA standards.

Given these information requirements, the following information should be disclosed and sufficient time should be allowed to digest it:

1. All participating entities: Organizations or individuals participating in an LBO or takeover must disclose the names, affiliations and business purposes of all associated individuals and entities that would financially benefit from or contribute financing to the LBO or takeover. This would include names and citizenship of institutions and entities in buyout funds, limited partnerships, owners of private corporations and individuals.

2. Past financial results and pro-forma projections: Pro forma and past financial statements (income statements and balance sheets), off-balance sheet obligations and interests must be disclosed for persons or entities directly filing or indirectly associated with the filing of a 13D with an intent to acquire controlling interest in a corporation.

3. The analysis which supports the "fairness" opinion provided to shareholders: The data upon which a fairness opinion is based should include the information to be required under items 1 and 2 above and that data and the subsequent analysis should be disclosed to the stockholder. The analysis must be based on timely information and reflect an analysis of past results as well as current and anticipated obligations.

4. A uniform, summary disclosure document should be required for all mergers and acquisitions: Currently much disclosed information is buried in documents that are long and unfathomable to the most readers. Just as consumer contracts and credit card interest disclosure must now be intelligible, so too should SEC filings intended to inform shareholders of their rights.

Conclusion

The measures I have suggested are aimed primarily at removing incentives for overly-leveraged companies. They are not aimed at revenue generation, but I believe that if our corporate infrastructure is healthy, income--both corporate and personal--will be generated.

Mr. COYNE. Thank you very much.
Mr. Courtney.

STATEMENT OF GUY W. COURTNEY, CHAIRMAN, CHICAGO CHAPTER, UNITED SHAREHOLDERS ASSOCIATION, AND SENIOR VICE PRESIDENT, DAVID A. NOYES & CO., PALATINE, IL

Mr. COURTNEY. Mr. Chairman, members of the committee, thank you. My name is Guy Courtney. I am senior vice president of David A. Noyes & Co., a Chicago-based brokerage firm, and member of the New York Stock Exchange. I am also here though representing as chairman the Chicago chapter of the United Shareholders Association. We would like to commend the committee for taking the time in what is sometimes—when a major event like the RJR-Nabisco deal occurs, there is a fanatic use of energy and activity that happens only to be found that incorrect conclusions are drawn. Thank you for taking the time to carefully deliberate on this issue.

The United Shareholders Association is a grassroots organization of 58,000 members representing all States in the Union. We represent shareholders that have really become the silent majority. But they should not be the silent majority because they, in fact, are the owners of America's corporations.

I will proceed by submitting my prepared statement for the official record and summarize the major points of our position regarding LBO's. Naturally, I am available for your questions.

Leveraged buyouts have made and are making America more productive, efficient, and more valuable. Now there are a few negative perceptions which tend to be somewhat emotional in nature suggesting that they damage the economy. Those statements cannot be backed up with much evidence at all. As a matter of fact, there is hard empirical evidence that suggests otherwise and specifically says that restructuring makes for better managed companies, more productive use of assets at those companies, and in fact, an area that some are envious of, is that shareholder value increases substantially.

In prior testimony that I have reviewed prior to attending here today, you have seen reports from the University of Chicago, two independent studies which specifically hold that restructuring is equivalent to significant performance gains at the corporation. That is because there is a new incentive that begins. Management's net worth becomes made up substantially of the stock in the company that they now own where previously they did not have that incentive.

On the way here yesterday on the plane I noted a Fortune magazine article which summarized some previously public companies which have now been taken private in management-led buyouts. It is interesting to note one of the chief operating officers at that company, now a private company, said that they were doing things currently that they should have been doing all the time as a public company. That is a strong indictment on the system as it now exists.

I do not mean to make leveraged buyouts sound all that rosy because I do have a major concern. That is, the inherent conflict of interest between managers on the one hand and shareholders on the other. It is a conflict that has to be reconciled by virtue of the fact that in management-led buyouts they are, for their own self-interest, trying to buy the company as cheaply as possible, and they are ignoring their fiduciary capacity to their shareholders. We only need look at the RJR-Nabisco situation to see that after the original offer was made, a final offer came in over $8 billion more than that original offer.

So it is important to make sure that the auction market is at work, that competitive bidding exists in these situations. So far, the courts have been extremely helpful in reminding board members that there is some significant liability out there should they fail in their fiduciary capacity.

This is still an ideal opportunity for Congress to evaluate some discrepancies in the tax system as I see them, and those are the preferences that exist between equity and debt. An elimination of the tax penalty on dividends is going to result in some tremendous things for this economy and the country.

First, it is going to increase dividend payouts. That is going to happen automatically. An increased dividend payout means additional tax revenues for the Government on the one hand. On the other hand—and after 14 years in this business—I have no problem saying that the market as measured by the Dow Jones Industrial Average, could indeed rise to 3,000, or 3,500 based on that. So I would suggest that the elimination of that double taxation would, in fact, be a revenue neutral event.

Treasury Secretary Brady also, not today but in prior testimony, brought to our attention that all of our major trading partners have tax systems encouraging equity creation by providing some relief for dividends. I hope that everybody is aware that we obviously do not want foreign corporations to have the upper hand or any type of advantage here in this country.

In conclusion, I will say that substantial evidence does exist, hard evidence which you have seen, new evidence that is being presented to you on leveraged buyouts, that LBO's are a vital and a necessary corporate restructuring process. The creation of debt in a corporate restructure proceeding does not appear to represent any threat to the economy. There has been no evidence presented and I have not seen any that says that this is the case.

If, however, after you have reviewed all of the testimony that you have had made available to you you determine that the present tax system needs some adjustment, I would urge that these adjustments reduce that double taxation of returns on equity capital rather than impose a similar penalty on the debt finance.

Thank you.

[The statement of Mr. Courtney follows:]

STATEMENT OF GUY W. COURTNEY, ON BEHALF OF THE UNITED SHAREHOLDERS ASSOCIATION

Introduction

Mr. Chairman and members of the Committee, thank you for inviting me to testify today. My name is Guy W. Courtney. I am senior vice president of a brokerage firm, David A. Noyes & Company, in Chicago, and chairman of the United Shareholders Association's Chicago chapter. I am here today representing the United Shareholders Association.

The United Shareholders Association is a national grassroots organization with a membership of more than 58,000 individual shareholders, representing all 50 states. USA advocates public and corporate policies aimed at promoting shareholder rights and improving management accountability to shareholders as key elements of a more competitive and prosperous American economy.

Leveraged buyouts, the subject of today's hearings, are an important part of a broad corporate restructuring movement which is making American corporations more productive, efficient and valuable. While concerns have been voiced about the negative consequences of corporate restructuring transactions, there is little -- if any -- empirical data supporting contentions that restructuring is damaging to the health of the economy.

To the contrary, an extensive -- and growing -- body of empirical evidence strongly suggests that the opposite is true.

Corporate restructuring, whether undertaken voluntarily by incumbent management, under threat of a bid for control from outside the company, or as a result of a change in corporate control, is creating better managed companies, more productive use of corporate assets, and substantial gains in shareholder value. USA has assembled a bibliography of significant studies in this field, which is attached as an appendix to my testimony.

Performance Gains

There is compelling new evidence that, in addition to rewarding shareholders with substantial share-price premiums, corporations restructured with LBOs are experiencing strong performance gains. Two separate studies by researchers at the University of Chicago reach strikingly similar conclusions on this point.

The empirical studies, performed by Abbie Smith and Steven Kaplan of the university's Graduate School of Business, show large increases in profitability result from the improved incentives experienced by the management team in an LBO. These incentives include a sizeable equity interest in the corporation by management and the necessity of generating cash flow to meet debt obligations.

The results appear to confirm that, in giving management a direct personal stake in the company's performance, LBOs are encouraging an entrepreneurial vigor that is seen all too rarely in the traditionally structured publicly owned company.

Conflicts of Interest

There is, however, one important aspect of the LBO transaction that concerns us. LBOs undoubtedly involve a greater conflict of interest between management and shareholders than any other type of restructuring transaction. In an LBO, which typically involves a management group buying out the holdings of the company's public shareholders, the personal interests of managers blatantly run counter to their fiduciary duty to shareholders.

The self-interest of managers involved in an LBO dictates that they pay shareholders the lowest price possible for their stock. Fiduciary duty, however, requires management to get the highest price possible for shareholders. This inherent conflict must be reconciled to ensure that shareholders are treated fairly and receive the gains that they are entitled to in the buyout.

Fortunately, fiduciary duty to shareholders, enforced by substantial legal liability, is winning out. This was clearly displayed in the $25 billion RJR Nabisco buyout which generated so much controversy. After the bidding was initiated by what was widely viewed as an inadequate $75 per share bid from the RJR management group, an independent committee comprised of the non-management members of the board of directors was formed to conduct a competitive contest for control of the company. Eventually, the contest was won by an outside party which topped the initial management bid by more than $8 billion.

As this example vividly illustrates, shareholders are best served in an LBO by competitive bidding. The framework for a competitive LBO auction market has been established by court decisions which now recognize the primacy of shareholder interests in a management-led LBO. Directors who fail to solicit outside bids for a company when an LBO is initiated by management face the risk of substantial personal liability. This enforcement of fiduciary standards by the courts appears sufficient to motivate directors to seek competing offers.

Debt Concerns

Much of the recent concern about LBO activity relates to the debt created by these transactions. While mindful of the consequences of excessive corporate debt levels, we have yet to see evidence that the leverage resulting from LBOs or broader corporate restructuring trends represents a threat. Current ratios of debt to equity on corporate balance sheets are not out of line with historical trends.

And, as Federal Reserve Board Chairman Alan Greenspan pointed out in his testimony to this committee last month, the majority of restructured firms are in stable, mature, non-cyclical industries which are less vulnerable to debt-caused difficulties in the event of an economic downturn.

Reduce Double Taxation of Dividends

Still, the current hearings represent an ideal opportunity for Congress -- and this committee in particular -- to evaluate how the current tax system may skew economic decisions concerning the creation of debt and equity. The current system penalizes equity through the so-called double taxation of dividends, which taxes returns on equity capital at both the corporate level, as profits, and when those profits are distributed to shareholders as dividends. Given the deductibility of interest expenses, the tax code creates a strong bias against equity finance.

This bias should be resolved by eliminating the tax penalty on dividends, not by imposing the same penalty on debt. The goal should not simply be a level playing field between debt and equity. A level playing field will not create a better, more rational system if the problems of equity finance -- higher costs of capital being chief among them -- are also imposed on debt. Moreover, the tax treatment of interest payments reflects long-standing policy allowing for deductibility of business expenses.

Perhaps most importantly of all, however, attempting to discourage debt creation by removing the deductibility of interest expenses for corporate restructuring would put U.S. firms at a competitive disadvantage to foreign corporations, which would continue to benefit from deductibility at home.

International Perspective

An international perspective is particularly appropriate in considering the taxation of debt and equity. Others who have testified here, including Treasury Secretary Nicholas Brady, have noted that all of our major trading partners have tax systems that encourage equity creation by providing tax relief for dividends at either the corporate level or on shareholder income taxes.

This point should not be lost as we place priority on American corporations fostering a higher level of international competitiveness. A cost-of-capital advantage for foreign corporations resulting from differential tax treatment could result in lost markets for American firms in the 1990s and beyond.

Totally eliminating double taxation by allowing corporations to deduct dividend payments in computing taxable corporate income would be the most desirable and rational objective of tax policy.

Allowing corporations to deduct dividend payments from their taxable income would likely encourage much greater distribution of earnings to shareholders, result in a substantial increase in the market value of outstanding equity securities, and serve as a spur to productive economic activity.

Two recent examples highlight the benefits of higher corporate dividends. Last month, General Motors' stock price climbed nearly $4.50 when the company announced a $1 per share increase in its annual dividend payments, along with a two-for-one stock split. And, in the closing days of last year, the stock of Quantum Chemical Corp. soared by more than $18.50 per share on announcement of a one-time $50 per share dividend payment.

We can only guess what the market response would be to elimination of the double taxation of dividends. But a Dow Jones Industrial Average of over 3,000 -- currently the Dow is around 2,300 -- would certainly be within the realm of possibility.

Tax Revenue Considerations

These effects, we believe, would offset much of the loss of tax revenues that one would otherwise expect from elimination of double taxation. We recognize, however, that conventional static revenue estimates would show a large loss of tax receipts from total dividend deductibility. With the federal budget deficit the focus of so much concern, such a proposal may well appear unrealistic at this time.

A positive first step toward more desirable tax treatment of equity can be taken without incurring substantial revenue losses, however. Allowing a deduction for some portion of the dividends paid on new issues of common stock would reduce the tax barrier to dividend payouts and increase taxable dividend distributions.

Lower Capital Gains Rate

An important companion step would be a reduction in the capital gains tax. A shareholder realizes returns in the form of either dividends or capital gains upon sale of his stock. Reducing the capital gains tax would be in keeping with the same principle that calls for more rational taxation of dividends. Reducing the tax on capital gains will reduce the double taxation of income generated in corporations and would likely result in a substantial increase in the market value of corporate equity.

Conclusion

In conclusion, there is substantial evidence that LBOs are an integral part of a vital and necessary corporate restructuring process which is making American corporations more efficient, competitive and valuable. Although the management-led LBO presents opportunities for severe conflicts of interest between managers and shareholders, the courts appear to be upholding the fiduciary responsibility of management to serve shareholder interests in these transactions.

The creation of debt in corporate restructuring does not now appear to represent a threat to economic stability. If, however, Congress determines that the present tax system must be adjusted to reduce incentives for debt creation, we strongly urge that these adjustments reduce the double taxation of returns on equity capital rather than imposing a similar penalty on debt finance.

Mr. Coyne. Thank you very much.

Mr. Kelso.

STATEMENT OF LOUIS O. KELSO, CHAIRMAN OF THE BOARD, KELSO & CO., NEW YORK, NY

Mr. Kelso. Thank you very much, Mr. Chairman, for letting me attend this session and speak. I urge the committee to read my written testimony and in the time available I will only touch a few of the highlights.

In doing so, I want to go back to some pretty elementary things that I think we are seriously overlooking. One of the documents that I have left with the members of the committee before the hearing is a booklet entitled Readings in Binary Economics. I would like to ask that you turn to page 75 in that and look at a diagram illustrating the logic of a market economy as laid out by Adam Smith and followed by the classical economists essentially since.

I want to point some things out. The magic of the markets, said Mr. Smith, is that the impartial mechanism, the free market on the one hand—this is the left side of the equation—determines the value of what is produced. That is a build up of costs of production. On the other hand, the same mechanism automatically measures the income automatically arising out of production distributed to those who participate in production. If they participate competitively, it allocates itself.

Now the logic of this, said Mr. Smith, is that everyone is born with economic power, labor power. It is private property. It is democratically distributed. Not that it is egalitarian, but it means that the differences are 1 to 10, 1 to 15 maybe, but no greater.

Since the only way to earn income in a market economy is to participate in production—there is no other legitimate way—and since everyone wants to live, everyone will participate in production to the best of his ability, and everyone will earn income. The value of what is produced will equal the value of the income distributed, and everyone will be motivated to do their best and to enjoy the fruits of production.

Now at the very moment Mr. Smith was speaking there was being born—he is the author of the capitalist revolution, I think we can say—the American Revolution, of course, 1776. But in the United States, that is approximately the date also of the beginning of the industrial revolution. That is the revolution which Mr. Smith did not allow for, and which modern economists do not allow for, and which our national economic policy does not take into consideration, astonishingly enough. That is a revolution against poverty and toil that changed the nature of work, changed the idea of work, the definition of work from something that was labor intensive to something that is capital intensive.

Now at that point our failure to understand it, which begins with Mr. Smith—and by the way, he derailed Marx's thinking which caused the destruction of private property in the Communist, Socialist countries. But he has also derailed our own because our national economic policy, which is basically the Employment Act of

1946, says that we can solve all our income distribution problems through labor.

The industrial revolution changed the definition of labor from something that people once could do with the powers of their minds and bodies to something they now must do through the powers of their minds, bodies, and capital. That is, land, structures, machines, and capital intangibles normally represented by common stock.

Now had we understood what the industrial revolution was doing, and had we understood the logic of a market economy, we would have adopted means to enable capital to grow where it is needed. That is to say, the ownership of capital. Capital works for its owners primarily. Who are those? That is every person who earns income.

We have not done that. We developed techniques of financing capital that make access to capital credit, which is the secret of gaining capital—you are not born with it like you are your labor power—available to the well capitalized. So that you have a scheme 200 years old now of making the rich relentlessly richer and of denying access to capital to the majority. Actually, 5 percent of the people in the United States own all the nonresidential capital.

Now this system is designed to blow up. I will tell you what the problems before this committee essentially are. You are struggling with the fact that we have reached the limits of redistribution. We have got a $3 trillion national debt. We have got a burgeoning trade deficit that cannot be controlled. We have tried to redistribute in many ways. The New Deal dealt with this then.

Essentially, the New Deal knew it had a mandate to solve the problem of how to get out of the Depression. And it did make one tremendous discovery. It discovered that in an industrial society, government must be responsible for economic policy. Nobody can deny that, and everything that we see today and since 1932 goes back to that essential idea.

But having discovered the highway out of the wilderness, the New Deal set the American economy on that highway faced 180 degrees in the wrong direction. We attack the effects of poverty. If you could not earn enough income, you got subsidies. You got various kinds. We all know the details. By wage legislation and by union cooperation, we have encouraged labor to earn more and more—I mean, to be paid more and more for the same work or diminished work input.

So that we have spent 50 years gradually changing the U.S. economy into a welfare machine. We have lost our leadership in 100 major industries because the customers do not want to buy the product of welfare. We have made it easier for foreigners to come in and take over our markets, to take our market power.

Now I invented the ESOP, and I invented it to begin this society's adapting itself to the industrial revolution. It enables employees of prosperous corporations to buy capital and pay for it, represented by stock, and pay for it out of its own income. All the talk about savings is a lot of nonsense. The kinds of savings that the rich do, which is where all the savings are, is buying capital out of capital's income. That is why they can do it.

That is what the techniques of binary economics do—and the ESOP is only 1 of 8. The other seven have been untouched. Three or four of them are more powerful than the ESOP. They are the tools this committee should be working with.

There is lots more, but I will relax with that. I have written my testimony. I have given you copies of Readings in Binary Economics, and copies of our book, which I think is the best case that can be made that it is the responsibility of this Government to create an economic environment under which people can earn a living, a good living. Most goods and services are produced by capital. They cannot do it without capital ownership.

Thank you very much.

[The statement of Mr. Kelso follows:]

HEARING BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
ONE HUNDRED FIRST CONGRESS — FIRST SESSION

WASHINGTON, D.C.

DOES THE ECONOMY NEED LESS PUBLIC SPENDING OR MORE PRIVATE EARNING POWER?

Memorandum by Louis O. Kelso
In Support of Testimony on Behalf of Himself
and Kelso & Company, an ESOP Investment Banking Firm
Headquartered at
350 Park Avenue
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MARCH 14, 1989

DOES THE ECONOMY NEED LESS PUBLIC SPENDING OR MORE PRIVATE EARNING POWER?

The Proponents

Louis O. Kelso is an economist, author, lawyer, and investment banker, who has devoted most of his professional life to explaining the logic of a free-market economy that has gone through 200 years of the Industrial Revolution compels it to enable its working people to equip themselves with the ownership of sufficient capital so that their job earnings can be supplemented with capital-sourced earnings; that the American capitalist system must work directly for the many, not just for the few; to developing the financing techniques for accomplishing the structural reforms necessary to broaden the capital ownership base, and to raise the capital-sourced earning power of the presently capitalless majority of families.

The best known of his eight basic reform strategies for accomplishing this, *each of which uses the same financing logic,* is the Employee Stock Ownership Plan (ESOP), towards the perfection of which Congress, between 1973 and 1988, has enacted some twenty laws.

Kelso & Company is the first and foremost ESOP investment banking firm, having been organized by Louis and Patricia Kelso and Joseph Schuchert in 1970. It is headquartered at 350 Park Avenue, New York, New York 10022, (212) 751-3939, and has offices in Newport Beach, California, and in San Francisco.

Mr. Kelso was assisted in the preparation of this memorandum by his wife and co-author, Patricia Hetter Kelso. He will be accompanied in testifying by Gary Kleiman of Kleiman International Consultants, Inc.

The Purpose of This Testimony

In his Press Release #5, dated February 17, 1989, the Hon. Dan Rostenkowski, Chairman of the Committee on Ways & Means, announced that in addition to learning first hand from the primary Administration policymakers, the Administration's justifications for the outlay and revenue proposals contained in the President's Budget, that the Committee is also interested "in the economic outlook and the basis for the economic assumptions" included in the President's Budget; whether the enactment of the President's proposals will result in a clear reduction of the governmental deficit in accordance with the Gramm-Rudman-Hollings Deficit Legislation, and that the Committee hopes to gain a "longer-term perspective on the economy and future budget deficits, including the prospects for continued economic growth and rising real incomes for all segments of the population."

Does the President's Budget and the Committee's Line of Inquiry Address the Economy's Real Problem?

The chief responsibility laid upon members of the House and Senate by the citizens who democratically elect them to their offices is that they, acting as the Congress of the United States, should establish the institutional framework which will enable the individuals and families to earn good livings reflective of the state of the technological arts today.

The Administration, in its Budget Proposal, and the Ways & Means Committee, in its proposed Hearings on the Budget Deficit, are addressing the question of how the Congress can meet its most essential obligations without raising taxes and without exceeding the limitations on expenditure of the Gramm-Rudman-Hollings Act.

We Submit That There Is a Still More Important Question Before the Ways & Means Committee and In This Hearing

Is excessive public spending really the cause of the budget deficit? Or is it lack of private earning power? The logic is inescapable. More than half of all state and federal taxes go to support transfer payments. If the poor and the working middle class were self-supporting, they would not need to depend on government subsidies for aid to families with dependent children, medical care, retirement income, food stamps, housing, schooling, etc.

Government *is* responsible for maintaining the prosperity of the U.S. economy. The New Deal decided that in the early thirties in response to the economic breakdown we call the Great Depression, and every administration, Democrat or Republican, since the New Deal has continued, properly in our opinion, to recognize this responsibility of government. The purpose of government, said Abraham Lincoln, is to do for the people what they need to have done, but cannot do for themselves.

But the New Deal, an administration that was elected with a clear mandate from the voters to find a way for the United States to overcome the Depression, accepted the responsibility but set the nation's economy charging off in the wrong direction by 180°. It launched a war on the *effects of poverty*! The result: laws redistributing income from those who earn to those who need, primarily through taxing, borrowing and spending. The result was staggering increases in taxes and, as the resistance to higher taxes arose, crushing increases in national debt and annual national deficits.

Tax Reduction Through Raising the Earning Power of the Economically Underpowered

The fiscal ailments confronting the American economy — rising permanent debt and annual deficits, high taxes, stunted economic growth, shrinking international economic stature, spiraling trade deficits, etc. — are direct consequences of our massive underemployment, and that, in turn, is an inevitable result of an anachronistic National Economic Policy ("NEP").

Our recommendation to Congress, made in lieu of any proposals for procrustean tax or budgetary reform, is that it correct the manifest and embarrassing *factual* error in the national economic policy, and that Congress then set about implementing the new and realistic policy.

These are the highlights of our underlying reasoning:

- Well over half of all taxes collected by government in the United States are levied on people who earn income, to take away part of their income in order to give it to people who need more income.

- The support provided by Congressional redistribution of income from people who earn it to people who need it, or need more of it, is not limited to the funding of "transfer payments," massive as they are.

    — By legislation adopted from time to time since 1932, Congress, generally with the active help and cooperation of labor unions, has rigged the price of labor in order to accord working people progressively more pay for progressively less work, thus converting the private sector, to a large degree, into a welfare machine disguised as business. This redistribution is paid for by consumers; by rising foreign trade deficits as we price our goods and services out of the international markets; and by additional taxes, rising national debt and rising annual deficits, required to fund the activities of businesses' largest customer: the United States Government.

  - Taxes levied, or incremental governmental deficits incurred, to finance various expenditures, including the staggering increases in the stockpiles of useless war goods purchased with admitted awareness that they cannot be used: "deterrents" aimed, in reality, at unemployment, rather than any international enemy.

  - These last two items rival in magnitude the admitted annual transfer payments. They are exacerbated year after year by massive increases in government debt service.

- The real flaw in the economic "system," if an economic plan so out of touch with reality can be called a "system," does not lie in the tax laws, but in the factually-defective National Economic Policy. The evil consequences of the unrealistic NEP began, of course, long before it was formalized into the (Full) Employment Act in 1946.

What is the Defect in the National Economic Policy?

Long before it was formalized into law in 1946, we lived by and operated the economy on an erroneous economic policy that can be traced to an assumption made by Adam Smith; one asserting that the only way for individuals to participate in production and to earn income in a private property, free market, capitalist economy is to work.

Capital (meaning land, structures, machines and capital intangibles, now normally owned through corporate common stock) was, and still is, treated like a catalytic agent. *Under our present National Economic Policy, it makes no difference who owns the capital employed in the economy, so long as there is plenty of it!*

The owners of nonresidential capital, a tiny 5% of the population, are treated as "trustees" of this catalytic agent; "trustees" selected by Providence for this very important, powerful and dignifying function. Many of them have so described their fortunate positions as owners of concentrated holdings of the thing that long before 1929 had become, quantitatively and qualitatively, the principal way for its owners to produce goods and services and to earn income.

The truth is that there are two ways, not just one, in which individuals in a private property, free market, capitalist economy legitimately may engage in production and earn income. They can employ, or have others employ, their privately owned labor power. But they can also employ, or have others employ, their privately owned capital, normally represented by capital stock, since most production is carried on in corporate form and most capital assets are owned through corporations.

Capital is not a "catalytic agent" in the production process. Owning capital is but one of the two ways (the other being the ownership of one's own labor power) through which individuals may engage in production and earn income.

This simple reality confronts the *factual* error in the national economic policy: not only does it make a vast difference who owns the capital at work in the economy, but owning significant capital, with rare exceptions, is the difference between being poor and not poor; between earning part of your personal income in a way consistent with the state of the industrial arts and being wholly dependent upon the preindustrial method for doing so; between the possibility of lifetime employment and income earning, and the virtual certainty of penurious, precarious unemployment or retirement in one's latter years. The truth is that the *sole* reason for an individual being poor is that he does not own sufficient capital.

Some of the Economic Consequences of the Factual Error in the National Economic Policy

Here are some of the principal consequences of maintaining and operating the economy on the basis of a national economic policy that blatantly misrepresents to all citizens the truth about how goods and services are produced.

- Rising federal deficits and rising permanent federal debt;
- Larger and increasingly unrepayable foreign indebtedness to the U.S. and U.S. banks;
- Rising federal and state taxes;
- Rising trade deficits;
- The decline of the United States' economy as the leading world economy;
- The debasement of U.S. craftsmanship;
- The spiraling concentration of personal capital ownership by the plutocratic minority.;
- The absence of personal capital ownership by the 95% majority;
- The adversary strife between management and labor;
- Rising alienation throughout the country, leading to narcotic use, terrorism, arson and what-not;
- Labor unemployment, including unemployment concealed as boondoggle, which we estimate to account for perhaps 25% of the presently "employed" labor force;
- The decline in the quality of economic life in the United States in the last decade;
- The continuation of a growing economic underclass within the country — people who simply cannot earn enough to live decent economic lives;
- The inability to raise the earning power of people who would purchase far greater quantities of goods and services if they could but afford to do so, thus creating the powerful consumer markets that powerful producers want and need;
- Our diminishing status as a world creditor nation and our return to the status of a debtor nation;
- The fact that our society is becoming increasingly uninsurable — a certain proof that business is slowly grinding to a halt.

When Did the Fateful Error in the National Economic Policy First Surface?

To answer this question, we need to go back, using hindsight again, for another look at one of the most important events in our economic and political history — the Great Depression. Before we do that, let's review.

The Use of the Taxing Power in a Private Property, Free Market, Capitalist Society

The purpose of taxation is, of course, to raise funds justly and fairly from all citizens of the country, to enable government to carry out, efficiently and reliably, its proper functions.

But the proper governmental functions of the state in a private property, free market, capitalist economy do not include government's engaging in the production of goods and services, unless the economy fails to function properly, and they do not include the redistribution of income or wealth from those who earn more of it to those who earn less, or none at all, unless, again, the institutions fostered by the state fail to fulfill the federal government's Constitutional obligation to enable all families to be economically autonomous and self-supporting: to *earn* a good living.

— In the latter case, while the government may provide welfare as an expedient, its primary objective should be to restore economic self-sufficiency to the underproductive.

The Strategic Error of the New Deal

The strategic error upon which most of the economic reforms of the New Deal were based, notwithstanding that its name did not come into usage until the Johnson and Kennedy Administrations, was what we call "The War on Poverty." It is not and never was a war on poverty, but rather a *war on the effects of poverty.*

The "War on the Effects of Poverty" reflects an incompleteness in our thinking about the cause of poverty — the same thought omission that gave us our unrealistic and increasingly unworkable National Economic Policy. To have avoided or corrected those errors, we should first have asked ourselves a simple, direct question: "Why are people poor?"

The answer to that question, when you finally discover it, is quite simple, stark, and irrefutable.

PEOPLE ARE POOR BECAUSE THEY
DO NOT OWN SUFFICIENT CAPITAL.

No matter what other shortcomings or problems they may have, people who own viable capital holdings are not poor.

Congress Must Give Policy Guidance to Our Labor, Business and Financial Institutions

It is elementary that the duty falls squarely on Congress to establish institutions that will efficiently, and in conformity with Constitutional safeguards, equip every citizen with capital ownership as the way in which goods and services are produced changes from labor intensive to capital intensive.

Nature obviously designed man for economic autonomy, and equipped each adult consumer with one labor power. Could Nature point the way any more clearly for our legislators to guide their structuring of the economy, as we progressively create more and more capital instruments to spare us toil and to improve the quantity, quality, and variety of goods and services we produce?

The National Economic Policy must be changed to recognize the facts of economic life — namely that capital input accounts for more (if measured in free-market terms) of the gross national product than labor does and that we are facing economic disaster because a mere 5% of the people own all the nonresidential capital!

How Might Congress Go About Correcting the Error?

The immensely important but erroneous National Economic Policy is set forth in a single paragraph in Section 2 of the Employment Act of 1946 (15 U.S.C. 1021). It refers to "employment" only in the conventional and historical senses of the word. But that, of course, conflicts with the reality that an individual can participate in production and earn income not only by employing, or having others employ, his privately-owned labor power, but also by employing, or having others employ, his privately-owned capital.

Only about a dozen words in the Act need to be changed or reinterpreted to correct this all-important policy declaration. The words we would suggest are in dark type in the following paragraph that otherwise conforms to the present law:

AMENDED DECLARATION OF POLICY

> *Section 2. The Congress hereby declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture,* ***banking, finance,*** *labor, and State and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment,* ***as labor workers and as capital workers, for all consumers desiring economic autonomy and self-sufficiency,*** *and to promote maximum employment* ***as labor workers, or as capital workers, or in both capacities, and maximum production and purchasing power.***

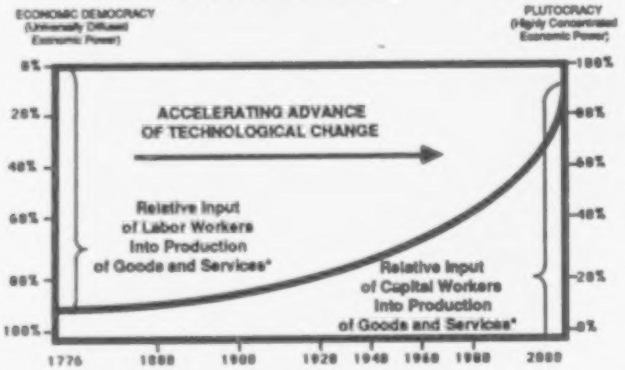
Every legislative draftsman has his own style, and there are many ways to effect the change in our policy laws to reflect that the Industrial Revolution has changed the meaning and idea of *labor* or *work* since Adam Smith first used them.

Is This Proposed Correction of the Factual Error in the National Economic Policy Too Radical for Congress?

It would be well, in considering this question, to address the meaning of the words "work" and "employment". The current interpretation of the National Economic Policy (which incidentally, is the national labor policy as well) is that only work or employment involving the use of the powers of one's body or of one's mind — human labor — is recognized as productive activity. That interpretation is diametrically contrary to the facts that, day after day, confront all people.

It is elementary that as the way in which goods and services are produced changes, through the ever-continuing Industrial Revolution, from labor intensive to capital intensive, the way in which people — not just some people, but all people — engage in production and earn their incomes should also change from labor intensive to capital intensive. The bounty of science and technology should not, and cannot, be reserved exclusively for the economic elite.

CHANGING PARTICIPATION of LABOR WORKERS and CAPITAL WORKERS in PRODUCTION of GOODS and SERVICES



*Estimated on the assumption that the value of productive inputs is measured in reasonably competitive markets.

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Failure to understand this simple reality, and failure to realize that we have all the institutions, if we would but use them properly, to enable people without capital to buy it, speedily pay for it, and thereafter engage in production and earn income through their privately-owned capital is a continuing cancer within our society. It has given both consumers and producers a century of various levels of self-imposed poverty, subdued production, depressed economic growth, misery and frustration. Obliviousness to these economic realities synthetically, unjustly and immorally divides Americans into two antagonistic camps: the non-productive "unemployed" and "retired" and the productive income earners, including both labor (service) workers and the tiny (5%) group of elite capital workers who own all the non-residential capital of the economy.

"Work" and "employment" are words that, rationally used, denote engaging in the production of goods and services either as labor workers, or as capital workers, or both, and earning income therefrom. It is nonsense for us not to recognize that if there are two ways in which each individual can engage in production and earn income, then in all economically-oriented discussion we must equally recognize as *work* both "labor work" and "capital work" that results in the production of useful and salable goods and services. And we must equally recognize "employment" as a labor worker and "employment" as a capital worker, and any pragmatically sound combination of the two, as ***employment***.

You are all familiar with the Employee Stock Ownership Plan — the ESOP. It is defined by Congress as a corporate financing device designed to build capital stock ownership broadly into employees of corporations, in ways that are mutually beneficial both to employers and employees. We have developed eight financing strategies, all using the well market-tested logic of the thousands of successfully operating ESOPs in the United States, capable in the aggregate of quickly and efficiently building viable capital estates into all American families. We estimate that most of the job could be accomplished in a decade; all of it could be done within two decades.

Implementing a Factually-Corrected National Economic Policy

Let's stop pretending that it makes sense to "create more jobs" for people who need more income and more time to pursue other goals of life than futilely trying to earn income by preindustrial means. Why do we proletarianize the lives of most American families? What our economy needs is about 150 million more capital workers. The technologically superseded idea of production, of work, as something people not equipped with adequate capital can do today leads only to strategic and fiscal disasters.

In 1988, aggregate capital transactions in the American economy exceeded $600 Billion. No more than 3% or 4% of those were ESOP-financed to achieve both efficient capital financing and to democratize capital ownership for employees. To implement a national economic policy that recognizes Adam Smith's free market principles today, we must take steps that will enable working people to equip themselves with capital to adequately supplement their labor power. If half of each of the capital financing transactions that took place in 1988 had been ESOP-financed, this could have put five million families on the road to becoming middle class labor and capital workers. If the policy were continued for ten years, half of America's families would be capital-equipped. The impact on economic growth, tax reduction, deficit-dissolving, and new job openings would be spectacular.

By belatedly correcting the error in our national economic policy, Congress could withdraw from its unseemly preoccupation with redistributing other people's money, and instead administer the soundly-restored economic policy which calls for enabling all underpowered, capitalless consumers to equip themselves with enough capital productive power to earn good incomes without government-enforced redistribution of income from taxpayers and consumers. *Homo laborens* would become *homo fabricans.**

But What About the Three-Fourths of the Population Who Do Not Earn Their Incomes Principally From Employment by Prosperous Corporations?

We estimate that only about 25% of Americans derive their incomes from jobs in prosperous corporations where ESOPs work best. But their problems in earning good livings are just as great, if not greater, and for an economic system to be acceptable and suitable to the people as a whole, it must give all those who live under the system the opportunity to earn a good living.

There are millions of people who earn only marginal incomes in self-employment, or in small and precarious enterprises. There are the millions of marginal farmers, government employees, school teachers, artists, scholars, writers, innumerable varieties of professional workers, the sick and the infirm, and those too old to hold employment.

That is why we developed seven other financing techniques, each one employing the well-market-tested logic of the ESOP, in order, when used either individually or in parallel with one or more of the others, to enable people to equip themselves legitimately and efficiently with viable holdings of productive capital. Each of the eight methods, except the Residential Capital Ownership Plan (RECOP), employs the "simulfinancing" principle that makes the ESOP so powerful, because it is both a highly efficient technique of corporate finance and a uniquely powerful and efficient way for individuals to accumulate savings — by buying and paying for capital out of its own income.

Brief Descriptions of the Eight Binary Financing Tools Built on ESOP Logic, of Which Only the ESOP Has Its Stockholder Constituency Defined by Corporate Employment

ESOP: Employee Stock Ownership Plan. The ESOP is designed to build capital ownership into employees of a business in the course of efficiently financing its growth or other worthwhile corporate objectives, without touching employee paychecks or savings. As to employees, the ESOP is that constitutionally-mandated missing link that gives them access to credit to buy the employer's capital stock and, without personal risk or liability, to pay for it from the pretax earnings of the assets underlying that stock. In other words, equalizing their access to capital credit with that of the already rich as a matter of according them their constitutional rights to equal protection of the laws.

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* Labor worker man would become capital (and labor) worker man.

MUCOP: Mutual Capital Ownership Plan. This financing method is intended to provide pooled ESOP financing for a number of corporations while building diversified portfolios of their stocks individually for their respective employees.

CSOP: Consumer Stock Ownership Plan. This technique is intended for use in public utilities, banks, insurance companies, and other businesses where long-term relationships between the producer and its customers are the rule. Through the intelligent use of credit, it builds capital ownership for customers while providing low-cost financing for growth of the corporation. The rate and extent of such growth is limited only by physical facts. It simultaneously raises the power of the consumers to pay for their purchases of goods and services while raising the power of the corporation to produce those goods and services. It would normally be used in conjunction with an ESOP for its employees.

GSOP: General Stock Ownership Plan. Designed to build capital ownership into politically-designated classes of consumers within the jurisdiction of the authorizing government — state, local or federal. While it is in need of several amendments, the text of a GSOP law was enacted by Congress in 1978. It was never actually used because it required counterpart state legislation, which was not forthcoming. The federal law has now expired by its own terms.

ICOP: Individual Capital Ownership Plan. A financing device intended to create viable capital estates for Congressionally-selected categories of individuals while opening broad markets for equity financings by corporations. This is potentially a more powerful tool than the ESOP. It would require broad use through the investment banking and banking systems, and could provide Congress with a means of stimulating economic growth and eradicating poverty on an unprecedented scale.

RECOP: Residential Capital Ownership Plan. This financing plan, in combination with commercially-insured capital credit financing, would enable homebuyers to purchase homes at less than 25% of the out-of-pocket principal and interest cost of similar transactions today, by having their acquisitions treated by tax and other relevant laws as capital assets, which they are, rather than as consumer items, as at present.

COMCOP: Commercial Capital Ownership Plan. Ownership of rental structures, such as office and apartment buildings, factories, mines, railroads, hotels, resorts, etc., are today a major source of capital-generated cash income. Today such structures and rental real estate assets generally are owned by the excessively wealthy (whose resulting income is thereby largely sterilized for purposes of the consumer economy, and denied to those who could use it if the financing has been COMCOP-structured), who use such acquisitions not only to satisfy their antisocial greed, but to wipe out their income taxes. COMCOP financing would enable commercial structure ownership legitimately to be spread over large numbers of people where it could raise their power to earn the incomes they need to make them powerful and self-supporting consumers, maintain their lifestyles, disalienate them, and to diversify their holdings in businesses in which they become employed as capital workers.

PUBCOP: Public Capital Ownership Plan. This plan is designed to provide low-cost financing for capital instruments used by public bodies of all types — office buildings, streets and sidewalks, parks, street lighting, schools, universities, subways, waterworks, harbors, etc. It permits broad individual stock ownership, through facilities corporations, by great numbers of people, while providing low-cost capital facilities to be leased at market rates to the cities and other municipal user corporations, the states, the federal government, and other public bodies that use or occupy such assets. PUBCOP financing is another tool in the arsenal of democratic capitalism to assure that each individual and family can become employed as a capital worker and that—as a matter of maintaining democratized social power (political and economic power)—governments do not acquire economic power that should be diffused throughout the citizenry. PUBCOP financing would employ the dual functions of other binary financing devices. That is, it would provide efficient and low-cost financing for public improvements and infrastructure, while generating private capital holdings for public employees and others selected by Congress as eligible stock buyers. It would be a major means of eliminating the cost of wasteful, inefficient, and inadequate public employee pensions, while providing much greater economic security and incomes, both before and after retirement, to public employees and others.

For fuller descriptions of each of these ESOP sibling financing tools, see Chapters 7 to 10 of *Democracy and Economic Power: Extending the ESOP Revolution*, Louis and Patricia Kelso, Ballinger (Harper & Row), New York, 1986. Copies of this book have been filed with the Committee and more will be provided on request.

See also "Readings in Binary Economics, The Foundation of ESOPs" filed as an exhibit with the Committee, particularly the article beginning on page 35, entitled "Leveraged Buyouts Good and Bad". One hundred copies of this pamphlet have been filed with the Committee.

The Future of Binary Financing

Of the eight binary financing tools, only the ESOP has been legislatively implemented. The ESOP is the first pragmatic step mandated by the changes in the idea and nature of work resulting from the Industrial Revolution. Common sense, the precarious posture of the U.S. economy, and the threat to our democratic freedoms from totalitarian concentrations of economic power within the U.S. economy, tell us that it is time to implement the most powerful of the other seven methods: the ICOP, COMCOP, CSOP, PUBCOP and RECOP.

Mr. COYNE. Thank you for your testimony.
Mr. Gates.

STATEMENT OF JEFFREY R. GATES, CONSULTANT, LONG LAW FIRM, WASHINGTON, DC

Mr. GATES. Thank you, Mr. Coyne, Mr. Ford. From mid-1980 to early 1987 I served as counsel to the Senate Finance Committee where I worked with Senator Russell Long in the design of ESOP-related legislation. I am appearing here today as a consultant to the Long law firm. It is my hope that the analysis I will share with you will lead you to conclude that this committee should exercise its influence to encourage leveraged buyouts to be structured to expand capital ownership by including in such buyouts the use of employee stock ownership plans [ESOP's].

For most working Americans, the secret to acquiring income producing property is still truly a mystery. The high visibility leveraged buyout is changing all that. People now recognize that entire corporations can be acquired for little or no cash. The well-to-do, of course, have known this for ages. They do not buy productive assets, they finance those assets, utilizing the common business logic that productive assets can pay for themselves, and thus, can repay debt incurred for their acquisition. That is the simple financial logic of a leveraged buyout.

An old financial maxim holds that if you do not inherit it, by God, you have got to borrow it. In that sense, an LBO is analogous to the 90/10 leverage used in borrowing to buy a home, an asset that will not pay for itself. In fact, in today's marketplace, given the availability of 30-year mortgages combined with 10 percent plus interest, a homeowner can pay for that nonincome generating asset three or more times before the debt is fully repaid. Sadly, that is currently the sole form of capital ownership to which most working Americans can ever aspire.

That is not to say that many people will not experience a leveraged buyout. Quite the contrary. As with acquiring their home with leverage, in an LBO they also are having to work hard to repay debt. Similarly, there is a great deal of risk involved. The difference, of course, is that although there is a widespread sharing of the risk in an LBO, there is seldom a widespread sharing in the rewards except generally among the top management employees.

Another key difference is that in an LBO the business logic of self-financing is at work, with the earnings on the acquired capital being utilized to repay the acquisition debt. Those projected earnings in turn enable the eventual beneficiaries of the LBO to access the credit necessary to acquire the target company.

ESOP financing is designed to address this anomaly and this inequity by encouraging this common business logic of self-financing to be applied so as to also economically empower a broad base of employees of the company whose capital is being leveraged. Several Federal tax incentives encourage this. To date there are 22 States that also have legislation promoting ESOP's. Unfortunately, these incentives have not yet proven sufficiently attractive that LBO's include ESOP's as a matter of course. To my knowledge, Kelso & Co. is the only firm that does so.

My primary purpose in appearing today is to urge this committee to play a more positive role in encouraging the use of financing techniques that expand capital ownership. To the degree that tax policy plays a part in LBO's that policy should operate to build capital ownership and a capital source of income for a broad base of taxpayers.

What happens if tax policy does not favor ESOP's in LBO's? Then LBO's will inevitably perpetuate, and indeed, increase the already intense concentration of capital ownership. To understand that requires understanding that practically all corporate funds come from only three sources: Retained earnings, which generate no new owners; tax benefits, primarily depreciation which create no new owners; and debt, which with the exception of LBO's is repaid for existing owners.

It is this "closed system of finance" that explains why the economy's capital base expands while its capital ownership base does not and will not. Sales of new equities are not a significant source of capital for corporations nationwide, and, of course, are now substantially negative due to stock buybacks.

The reason the current technology of finance fails to empower a broad base of taxpayers is very simple: it is not yet designed to. Prior to the advent of ESOP financing, policy and practical restraints made this closed system virtually impenetrable. For example, it is difficult to access retained earnings because by the time they are retained they belong to someone.

It is also difficult to do this through depreciation because the asset must be placed in service, and at that point the depreciation belongs to someone. It is also difficult to do it through debt because in order to attract debt you must have collateral. And of course, equity purchases require cash, and it is those already within this "closed system" who are best able to afford the purchase of those equities with their discretionary income.

The point is that current tax policy supports this closed system of finance, a tendency that can only be changed if policy actively begins to favor instead of ownership expanding financing techniques. Given today's capital financing practices, LBO's are destined to make the rich richer. ESOP's are the only way that that can be changed.

There are a number of advantages to this which have been detailed in my testimony. As the time is short, I will not list them. Let me mention only that ESOP's are not social investment. Social investment is an attempt to direct certain types of investments, typically to provide jobs for a politically favored group. Rather than favor particular investments, the ESOP concept suggest that whichever investments are made those investments should be structured to economically empower a broad rather than a narrow group of consuming households.

In conclusion, finance you will find is a type of technology, a social technology. Its practitioners use technological terms to describe it; terms like leverage, which is an analogy from mechanical technology, and cash flow, a metaphor that comes from hydraulic technology. Although that technology is invisible and intangible, its operations touch each of us every day.

During 1988 the U.S. economy, using that technology, undertook $741 billion in capital financings, $430 billion in business expenditures in new plant and equipment, and $311 billion in merger and acquisition activity, including LBO's. That is a lot of economic empowerment. Unfortunately, that empowerment was not widely shared.

So if I have succeeded here today, I hope I have at least helped make visible to you how this technology operates and how the policies of this committee can operate either to empower or to impoverish U.S. citizens. It is a subtle political irony that Government itself must operate to ensure that our free enterprise system does in fact operate to empower those within the system.

Given the way today's closed system of finance operates, we have an obligation either to act or to knowingly accept the consequences of our inaction. I hope that I have made it clear to you the consequences of this committee's continued inaction.

Thank you very much.

[The statement of Mr. Gates follows:]

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Testimony before the Committee on Ways & Means concerning Leveraged Buyouts

by
Jeffrey R. Gates, Consultant

March 15, 1989

Introduction

From mid-1980 to early 1987, I served as counsel to the Senate Committee on Finance where I worked closely with Senator Russell Long in the design of legislation to encourage the use of employee stock ownership plans (ESOPs) as a capital ownership-broadening technique of corporate finance. I am appearing today as a consultant to the Long Law Firm.

It is my hope that the analysis I share with you today will lead you to conclude that this Committee should exercise its influence to encourage leveraged buyouts (LBOs) to be structured to expand capital ownership by including in such buyouts the use of employee stock ownership plans.

My testimony consists of two parts. The second part is a summary of suggested recommendations should this Committee conclude, as I hope it will, that tax policy -- particularly as it affects the financing of income-producing assets via LBOs -- should favor those financings that serve to economically empower a broad base of taxpayers. This first part contains my analysis; a summary of principal points appears at the front.

Part I: Productive Assets Pay for Themselves

For most working Americans, the secret to acquiring income-producing assets continues to be a mystery. The high-visibility LBO is changing all that. People now recognize that entire corporations can be acquired for little or no cash. The well-to-do, of course, have known this for ages; they do not buy productive assets, they finance those assets, utilizing the common business logic that productive assets can pay for themselves and, thus, can repay debt incurred for their acquisition (the financial logic now being adapted to LBO financing).

An old financial maxim holds that if you don't inherit it, you must borrow it. In that sense, an LBO is analogous to the 90:10 leverage used in borrowing to buy a home, an asset that will not pay for itself. In fact, in today's marketplace, given the availability of 30-year mortgages combined with 10%-plus interest, a homeowner can pay for that non income-generating asset three or more times before the acquisition debt is fully paid. Sadly, that is currently the sole form of capital ownership to which most working Americans can ever aspire.

That is not to say that many people will not experience a leveraged buyout. Quite the contrary. As with acquiring their home with leverage, in an LBO they also are having to work hard to repay debt. Similarly, a great deal of risk can be involved: if the debt (mortgage) is not repaid, there is the possibility of default and even possibly bankruptcy (foreclosure).

The difference, of course, is that although there is a widespread sharing of the risks in an LBO, there is seldom a widespread sharing in the rewards (except, generally, among top management employees). Once the debt is repaid, the capital thereby acquired is seldom financed so as to include as owners the rank-and-file employees (or middle management employees) -- those whose efforts were essential to pay down the debt.

Another key difference is that, in an LBO, the business logic of "self financing" is at work, with the earnings on the acquired capital being utilized to repay the acquisition debt. Those projected earnings, in turn, enable the eventual beneficiaries of the LBO to access the credit necessary to acquire the target company.

ESOP Financing

The employee stock ownership plan (ESOP) concept is designed to address this anomaly (and inequity) by encouraging this common business logic of "self financing" to be applied so as to also economically empower a broad base of employees of the company whose capital is being leveraged. As with the LBO, ESOP financing utilizes the corporation's access to credit to finance the capital acquisition.

Several Federal tax incentives encourage this ownership-broadening approach to capital financing.[1] To date, 22 States have enacted legislation promoting employee ownership.[2] Unfortunately, those incentives have not yet proven sufficiently attractive that ESOP financing is included in LBOs as a matter of course.[3] To my knowledge, Kelso & Company is the only firm that does so.

My primary purpose in appearing today is to urge this Committee to play a more positive role in encouraging the use of financing techniques that expand capital ownership. To the degree that tax policy plays a part in LBOs, that policy should operate to build capital ownership (and a capital source of income) for a broad base of taxpayers, thereby benefitting the overall economic health of the nation.

What if Tax Policy does NOT Favor ESOPs in LBOs?

If leveraged buyout financings do not begin to include an ownership-broadening element (i.e., beyond broadening ownership among a few executives), LBOs will inevitably perpetuate and, indeed, increase the already intense concentration of capital ownership in the economy.[4] To understand why that is the case requires a recognition that practically all corporate funds are provided through but three sources:

1. Retained earnings - which create no new owners,

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[1] A summary of the Federal tax incentives for ESOPs appears as Exhibit A.

[2] One of the most active is New York. The Cuomo Commission Report (1988) recommends that "employee ownership be made a central part of state and national economic strategies." Governor Cuomo refers to employee stock ownership as "supply side for workers". Business Week, April 11, 1988, p. 79.

[3] A chart depicting the low percentage of LBOs that include an ESOP is included as Exhibit B.

[4] A capital ownership profile appears as Exhibit C. Note that this profile undoubtedly badly understates wealth concentration because it is based on 1983 date utilizing earlier research that fails to reflect the effect either of the tax incentives for investment enacted in 1981 or the subsequent dramatic increase in merger and acquisition activity (including LBOs). For example, in 1982, average wealth of the "Forbes 400" richest individuals was $200 million; by 1987 average wealth topped $550 million.

2. Tax benefits (primarily depreciation) - which create no new owners,[5] and
3. Debt - which (except via LBOs) is repaid for existing owners.

It is this "closed system of finance" (a term coined by the U.S. General Accounting Office) that explains why the economy's capital base expands while its capital ownership base does not. Sales of new equities are not a significant net source of corporate funds nationwide and are now substantially negative due to the volume of stock buybacks.[6]

The reason the current "technology" of capital finance fails to empower a broad base of citizens is simple: it is not (yet) designed to. Like so much of our institutional life, it just sort of grew - unintentionally, incrementally, accidentally - most of it enforced not by rule so much as by common business practice.[7]

Prior to the advent of ESOP financing, policy and practical restraints made this "closed system" virtually impenetrable. For example, it is difficult to access retained earnings for this purpose because, by the time those earnings are retained, they belong to existing capital owners. Similarly, the cash flow available through depreciation is available only once the asset is placed in service and, by then, the asset (as well as the accompanying depreciation) belongs to someone.[8]

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[5] For 1975-1985, the two primary corporate tax benefits for capital financing totalled $1,056.6 billion, comprised of $158.7 billion of investment tax credit and $1951.9 billion of depreciation deductions. (Internal Revenue Service SOI Bulletin, Fall, 1988). Given today's capital ownership pattern, approximately half of those tax benefits (i.e., $528.3 billion in tax savings) were used to finance additional income-producing assets for the already wealthiest 3-5% of U.S. households. At present, tax policy characterizes depreciation as a policy designed to preserve the ownership of capital assets (i.e., by not taxing the earnings on those assets until their cost is recovered). Yet depreciation (as a fundamental component of corporate cash flow) is also a key determinant of access to the ownership of capital assets. For example, a borrower with access to the cash flow of depreciation on assets is better able to attract the debt necessary to acquire those assets (i.e., because depreciation deductions accompanying those assets "tax shelter" an earnings stream that can instead be directed to debt repayment).

[6] See Exhibit D.

[7] The Federal Reserve is a partner in the process that perpetuates this "closed system" -- by facilitating bank credit to fuel this system (e.g., via its discount rate operations) and by accommodating deficits incurred to finance tax benefits that feed this system (e.g., by its open-market operations). LBOs are likewise Fed-facilitated (for example, when LBO-related bank debt is presented for discount by member banks, thereby expanding the money supply). The ownership of government debt securities (another income-producing asset) is similarly concentrated. The Treasury estimates that, of those securities held by U.S. individuals, 93% are owned by 10% of the population while 71% are held by just two percent. That form of "wealth" totalled $900 billion in 1980; it now approaches $2,700 billion and will soon reach $2,800 billion. The annual ownership income earned on that form of wealth (i.e., taxpayer-provided interest payments paid to non-government holders of U.S. securities) now exceeds $150 billion.

[8] See footnote 5.

Likewise, qualifying for the debt necessary to buy assets on a self-financing basis is difficult in the absence of collateral, a scarce commodity among non capital owners.[9] Equity purchases, of course, require cash, and it is those already within this "closed system" who can best afford to purchase those new equities -- with the discretionary income generated by their already-owned capital.

The point is that current tax policy supports this "closed system" of finance, an ownership-concentrating tendency that can be changed only if that policy begins actively to favor instead ownership-expanding financing techniques. For example, whenever the cash flow of an interest deduction (or a depreciation deduction) is utilized to repay LBO debt, that deduction helps to finance for someone the acquisition of income-producing capital.

Given today's capital financing practices, LBOs are destined to accelerate the trend to "make the rich richer". However, by understanding the dynamics of this "closed system", tax policy (particularly when combined with other Federal and state policies) can begin the process of opening today's closed system to benefit more taxpayers.

Advantages of an Expanded Ownership Tax Policy

By more actively encouraging ESOP participation in LBOs, tax policy can address a multitude of economic and social issues while simultaneously helping to economically empower those employed by LBO companies by enabling them to share in the success they help to create.

ESOP-oriented financing provides a new way to strengthen the long-term relationship between capital markets and corporations. Employees (and the communities in which they live) are the primary corporate stakeholders. Unfortunately, those stakeholders are seldom shareholders.

By favoring investment practices that foster ownership by a corporations' natural shareholders (i.e., its stakeholder-employees), tax policy can begin to create an environment in which shareholders (and capital markets) look to the corporate entity as a long-term provider of jobs and economic strength, and as a producer of high-quality goods and services, not just as a vehicle for financial speculation.

Employee stock ownership financing also enables tax policy to positively impact corporate performance and spark economic growth by improving motivation, productivity, commitment, dignity, morale, competitiveness, quality, creativity, labor-management relations, workplace participation, job satisfaction, etc. Common sense suggests (and experience confirms) that companies with employee stock ownership perform better than those with largely absentee ownership.

For those industries that must compete in world-wide markets (particularly those markets with lower labor costs), an ownership-source of income is rapidly becoming a component of employee compensation essential to maintaining price competitiveness (e.g., the steel industry).

This approach to tax policy can also help promote "patient" capital by facilitating a corporate environment able to focus on the long term while also helping to "anchor" that capital, preserving the economy's (and communities') job-creating (and tax) base.

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[9] ESOP tax incentives address the way in which this "closed system" limits access to debt-financed capital. IRC Section 133 encourages commercial lenders to structure loans that expand capital ownership via ESOP financing. See exhibit A (item #5) for a summary of this incentive.

Such an approach to tax policy can also help buffer companies against unwelcome takeovers as employee stock ownership creates a body of interested, long-term shareholders able to offer protection from today's roving, global pools of takeover capital. This protection, in turn, can help bondholders protect against the erosion in value that can occur when the bonds of a target company are downgraded due to the imposition of LBO debt.

An ownership-broadening tax policy can also update the role of tax policy in promoting economic opportunity by helping to create widespread income opportunities not just from job opportunities but also from opportunities to own capital, arguably a more relevant approach to economic opportunity in a capital-intensive, post-industrial job environment.[10] Whereas most LBOs impair employees' earning power, ESOP LBOs (by financing income-producing capital for employees) enhance employees' earning power.

As a form of fiscal foresight, this capital ownership-broadening tax policy also has much to recommend it. Over a period of years, this approach can help anticipate and relieve the nation's out-year fiscal strains that will otherwise stem from an aging baby boom generation and their inevitable need for entitlement programs should tax policy allow them to become an asset-poor "senior boom".[11]

Continued reliance on current techniques of capital finance guarantee a continuing lack of widespread economic self sufficiency which, in turn, guarantees steadily worsening fiscal pressures -- not only from the growing need for entitlement programs but also from increased pressure for job (i.e., income) creation through public spending (e.g., defense spending and other fiscal-funded "jobs"). This widespread lack of economic empowerment saps the economy's economic strength while directing resources into unproductive, counterproductive and even dangerous uses.[12]

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[10] Note that today's "full" employment is partly the result of demographics (a baby bust after the baby boom) and partly the result of low investment (e.g., in Japan, robots are doing tasks still assigned to U.S. workers). See Report of the National Economic Commission (March 1, 1989).

[11] For most American households, their largest single "asset" is their entitlements under the Social Security system (i.e., an assurance that someone else will be taxed on their behalf). To the degree that the growing Social Security surplus is invested in government debt securities, the next generation will have to pay higher income taxes (or sell more bonds) to finance the repayment, as well as Social Security taxes to finance their parent's retirement. Rather than dissipating those funds for government operating costs, those funds could instead be invested in the stocks and bonds of a diversified portfolio of companies, thereby funding the system with real (vs. phantom) assets while also contributing to the nation's productive capacity and driving down the cost of adding to that capacity. Given the otherwise ownership-concentrating nature of the "closed system" of finance, those investments should be limited to companies that utilize ownership-expanding financing techniques (e.g., ESOPs). Simply put, people need entitlements because they don't have assets. Applying more foresight to the financing of this nation's assets (i.e., so as to create widespread economic empowerment) could reduce the fiscal strain of the "hindsight" financial empowerment now done via entitlements and other redistributive income-maintenance devices.

[12] If, as technology moves through time, economic policy fails in connecting consumers to their market economy with capital ownership (rather than just with jobs) there will develop a need to find other ways to distribute income so as to maintain a broad base of consumer demand. "Defense" spending has traditionally been one of the most popular income opportunities government has created to address this thusfar intractable problem, an approach with a certain perverse economic logic to it because "defense" spending

ESOPs are Not Social Investment

ESOP-favored financing is not "social investment". Social investment is an attempt to direct funds into projects that the marketplace may otherwise not finance (usually to provide jobs to a politically-favored group). Rather than favor particular investments, the ESOP concept suggests that, regardless of which investments are made, tax policy should encourage those investments to be structured so as to economically empower a broad rather than a narrow group of consuming households.

Indeed, the ESOP concept suggests that if we truly intend to have a market economy (i.e., in which income is based on economic inputs), present tax policy undermines that intent by supporting financing techniques that build so many economic inputs (i.e., capital ownership) into so few households while leaving so many with only their labor as their "input" with which to generate income in today's capital-intensive (and increasingly global) economy.[13]

The Social Technology of Capital Finance

Capital finance is a type of social technology. Its practitioners even use technological terms in describing its ofttimes arcane workings, terms such as "leverage" (an analogy to mechanical technology) and cash "flow" (a metaphor from hydraulic technology). Even though that technology is invisible and intangible, its operations touch each of us every day.

Financial technology is the "software" that connects us to this nation's hardware: the technology embodied in our economy's capital instruments and other means of production. Properly designed, this financial technology can represent progress of the highest order, with this culture's labor-saving, job-displacing, income-producing technology designed to empower a broad base of those whose culture gave rise to that technology.

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creates jobs which create income which creates consumer demand -- but without the danger of creating consumer-useful goods or services that will show up in the marketplace -- requiring the creation of additional consumer demand to buy those goods and services. Congressional debates about "defense" are largely debates about jobs in Congressional districts (e.g., witness the current debate over military base closings or over the production situs of the FSX jet fighter). It was World War II that finally pulled the U.S. economy out of the Great Depression (in conjunction with other income-redistribution/job-creation approaches enacted during Roosevelt's New Deal). The Full Employment Act of 1946 (still the principal guiding light of national economic policy) emerged from the Senate War Demobilization Committee. Forty-three years later we still have a war-time military and war-time deficits (as well as the same jobs-fixated national economic policy).

[13] Absent government intervention, market forces direct income to those with economic inputs. Thus, it should come as no surprise that, as the ownership of inputs (capital assets) becomes more highly concentrated (and as those capital assets displace human skills in the production process), the concentration of income also becomes more concentrated. Thus, it now takes two paychecks to do what one did a few decades ago. By a substantial margin of 58 to 30 percent, respondents to a recent Gallup poll for The Los Angeles Times said that the gap between the rich and the poor is getting wider. See The Washington Post, March 9, 1989 at p. A5. The income share going to the bottom 40% of households is now the lowest since 1953 while the income share going to the top 20% of households is the greatest since 1947. If you compare the percentage of income going to the richest 20% of households with that going to the poorest 20%, the U.S. now ranks 18th of 24 major countries, just ahead of Brazil and Mexico.

During 1988, the U.S. economy undertook $741.2 billion in capital financings: $430.2 billion in business expenditures in new plant and equipment[14] and $311 billion in merger and acquisition activity (including LBOs).[15] That is a lot of economic empowerment. Unfortunately, that empowerment was not widely shared: the already well-to-do are much better off; others are struggling to hold their own while many are slipping back.

For 1989, the U.S. economy is projected to finance more than $450 billion in new plant and equipment. At that pace, we will bring on line approximately $10,000 billion in new, income-producing assets between now and the year 2010 when the first baby boomers begin to reach age 65.[16] None of that capital is yet owned by anyone. Yet unless tax policy helps change how we finance productive assets, today's "closed system" of finance will ensure that fully half of that $10 trillion will be financed for the already-wealthiest five percent of U.S. households.

Conclusion: Tax Policy a Key Ingredient

I will have succeeded here today if I have made visible to you how the "invisible technology" of capital finance operates, and how its operations -- fueled by the tax policy advanced by this Committee -- can operate either to empower or to impoverish U.S. citizens. ESOP-favored financing, particularly in the context of LBOs (where enormous amounts of capital are changing hands), provides an opportune and innovative way for tax policy to begin to economically empower a broader group of taxpayers.

An economic future in which the bulk of this nation's capital assets continue to be financed for only a few is a future that cannot be sustained. In fact, it is a future that undermines the ability of a free enterprise market economy to do what it does best: distribute income according to the distribution of economic inputs. A tax policy that supports financing practices that, in turn, support the concentrated ownership of economic inputs is a policy that endangers free enterprise by requiring a greater redistributive role for government.

It is a subtle political irony that government must itself act to insure that our free enterprise system does, in fact, operate to empower those within that system. Given the way in which today's "closed system of finance" operates, we have an obligation either to act or knowingly to accept the consequences of our inaction. I hope that I have made it clear to you the consequences of this Commitee's continued inaction.

Part II: How Can Tax Policy Expand Capital Ownership?

An understanding of credit and cash flow is the key to designing a tax policy that can expand capital ownership. Examining the dynamics of today's "closed system of finance"[17] provides numerous clues as to how tax policy (as well as other government policy) supports access to the credit used to acquire capital assets -- primarily by providing access to cash flow that can be used to service debt incurred to acquire those assets.

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[14] Economic Report of the President (January 1989), p. 369.

[15] According to the New York City research firm IDD Information Services, accounting for 3,637 U.S. transactions.

[16] This figure disregards capital-transfer financings such as mergers and acquisitions (including LBOs).

[17] See explanation at page pp. 3-4.

The following material summarizes some of the approaches that the Committee should consider if it decides to favor expanded rather than concentrated capital ownership. These recommendations focus on proposals designed to encourage ownership participation through the employment relationship generally, and specifically through the encouragement of employee stock ownership (primarily via ESOPs).

Other economic relationships could also be adapted to this ownership participation concept (for example, encouraging utilities to be financed so as to create stock ownership among both employees and consumers).

A. Transform Existing Tax Benefits. Expanding participation in capital ownership need not require new tax incentives; it is possible both to raise revenue and to expand capital ownership by transforming existing tax benefits to achieve the ownership-expansion goal. The following list is meant to be suggestive not exhaustive, and is directed primarily at encouraging the inclusion of employee stock ownership in LBO financings.

(1) Tax Code-assisted Capital Transfer Financings. Disallow the corporate tax deduction for interest expense incurred for capital transfer financings (e.g., mergers, acquisitions, recapitalizations and leveraged buyouts) unless, in conjunction with such transactions, a prescribed portion of the corporation's equity (e.g., 10%) becomes owned by a broad group of employees (e.g., through an ESOP). Could be limited to transactions above a certain size.

(2) Incentive Element of Depreciation. Require that a substantial portion of the taxpayer-provided cash flow attributable to the incentive element of depreciation be utilized to acquire employer capital for employees. Companies wishing to expand their capital base (or transfer ownership) without expanding ownership could have access to the cash flow of straight-line depreciation based on the true economic life of the asset. This could be effective as cash flow is the life blood of LBOs. Could be limited to companies above a certain size.[18]

(3) Corporate Tax Rates. Provide a sliding corporate tax rate, with lower rates available for those companies maintaining a prescribed level of employee stock ownership. This ownership participation level could begin low (e.g., 5%) and increase over a period of years (e.g., to 25%). Because of the effect on corporate cash flow, this approach could be effective, particularly in encouraging inclusion of an ESOP in the mid or later stages of an LBO's payout period. Could be limited to companies above a certain size.

(4) Pension Plan Reversions. Reinstate IRC Section 4980(c)(3) permitting an employer to recover excess defined benefit pension plan assets tax-free provided the cash is used to buy employer stock via an ESOP or is used to repay an ESOP loan. With this policy compromise, the employer has access to the cash attributable to the

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[18] See discussion at footnote 5 indicating a policy rationale for conditioning some portion of non-incentive depreciation on expanded capital ownership, particularly in the context of ownership-transfer financings.

overfunding provided the cash is used to create value for employees by buying for them employer stock.[19]

(5) Savings Incentives Linked to Employee Stock Ownership. Reduce the $7,000 contribution limit for 401(k) plans to $5,000, allowing the additional $2,000 provided that amount is invested in employer securities for at least three years. The 1986 Senate Finance Committee tax reform bill included a provision allowing an additional $2,500 for 401(k) contributions to ESOPs (for a total of $9,500). This approach could assist employees of LBO companies in acquiring a stake in their employer's LBO.

(6) Pension Plan Investments. Disallow a portion of the tax exemption now permitted on the earnings of defined benefit pension plans unless a prescribed portion of such assets are invested either in notes associated with ESOP financing or in stocks or bonds of companies maintaining a minimal level of employee stock ownership (e.g., 10%). This approach should also help direct pension fund LBO investments into ownership-broadening LBOs. Could be limited to plans above a certain size.

(7) Reduced Capital Gains Tax. Provide a reduced capital gains tax for those selling their stock to an ESOP. This concept was approved by the Senate in 1984 requiring as a condition that, after the sale, at least 50% of the company's stock is owned by at least 50% of the non-management employees. A similar bill, introduced in 1981, required also that the company maintain a research and development budget averaging 2.5% of gross revenues for the three years prior to the sale. This approach could encourage the inclusion of ESOP financing as part of the tender offer structure in an LBO.

(8) Dividend Deduction. Allow a partial (and increasing) corporate deduction for dividends paid provided the paying corporation maintains a prescribed (and increasing) level of employee stock ownership.[20] This approach should attract more equity into LBOs while also encouraging the inclusion of ESOPs in LBOs.

(9) Extend the "ESOP Rollover. Allow stockholders of publicly traded companies to defer capital gains tax on the sale of their stock to a company's ESOP provided that, after the sale, the ESOP holds a minimum amount of the company's stock. This approach could encourage inclusion of an ESOP as part of an LBO's financing (and tender offer) structure.

(10) Charitable Business Transfers Treat an ESOP as a charitable organization for income, gift and estate tax purposes (approved by the Senate Finance Committee in 1984), thereby encouraging business owners to leave their

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[19] As an example of the power of financial leverage (and the role that those excess assets can play in accessing that leverage for the benefit of employees), consider: in the 1988 LBO of American Standard (in which Kelso & Company acted as a "white knight" in fending off a hostile bid by Black & Decker), the $50 million in excess pension assets transferred tax-free to the company's ESOP acquired for 7,000 of American Standard's U.S. employees a 19% stake in a $3 billion transaction involving a multinational corporation employing 35,000. In most LBOs, those excess assets are instead simply recovered by the company (less a 15% excise tax).

[20] More than just revenue constraints prevent enactment of any of the various approaches to integration of the corporate and the shareholder tax. For example, approximately 46% of dividends paid to individuals are paid to one percent of U.S. households. In addition, much of what is now accomplished in LBOs with high-yield quasi-debt (i.e., high-interest "junk" bonds) could instead be accomplished with high-yield quasi-equity (i.e., high dividend preferred stock).

companies to those who helped build them. This should be a revenue gainer, particularly where such wealth would otherwise have been left to charity. Approved by the Senate Finance Commitee in 1984.

(11) Subchapter S Corporations. Allow Subchapter S corporations to establish ESOPs. The Tax Reform Act of 1986 created an anomaly in that "Sub S" status is attractive but such corporations are currently precluded from establishing ESOPs. The amendment can be structured in a revenue-neutral manner.

(12) Ownership Impact Report. Whenever a tax initiative is proposed that impacts capital ownership, require an estimate of both the revenue impact and the ownership impact. Had Congress understood both in 1981, it is unlikely that they would have approved such legislative largesse (i.e., the deficit-financed cash flow pumped into the "closed system of finance" through enactment of the accelerated cost recovery system).[21] Should the filing of an ownership impact report be required in conjunction with LBOs?

(13) Greed Tax. Certainly a "wealth tax" should be avoided - yet when wealth accumulations reach what anyone could agree is obvious greed, a limitation may be appropriate (e.g., a 25% tax on accumulations in excess of $100 million).[22]

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[21] See Footnote 4. In April 1984, Treasury Secretary Regan testified before the Senate Finance Committee concerning why record-breaking deficits were not choking off the economic recovery due to the "crowding out" of private borrowing by government borrowing. The reason, he testified, was because of corporations' "capacity for self financing" -- a phrase best understood by reviewing the "closed system of finance" described at pages 3-4 above. Consider: with deficits being used to fund capital financing tax benefits (i.e., the cash flow of the accelerated cost recovery system), weren't shareholders of those corporations partially relieved of the need for their companies to be in those markets? How could they be "crowded out" if government was, in essence, doing their borrowing for them (i.e., incurring deficits to finance corporate cash flow)? Could that be part of the reason more of the economy's private credit capacity became available to fund the subsequent increase in merger and acquisition activity? Was that "self" financing or "us" financing -- as in us taxpayers got the mortgage (the deficits) while someone else (shareholders) got the house (i.e., those assets financed with that cash flow). Indeed, it appears that we taxpayers are also making the mortgage payments to the same small group that got the house (see footnote 7).

[22] Although the financial acumen of LBO experts (and the management expertise of key executives) is undoubtedly quite valuable, it is not so valuable that they should, with the LBO device, be able to assign to themselves such vast sums of income-producing capital that others affected by the transaction are thereby precluded from even a modest level of capital ownership, particularly considering: (a) the many taxpayer-assisted elements of LBO financing, (b) the many reasons Congress supports employee stock ownership, and (c) the pressing fiscal need to create widespread economic self sufficiency. However, an exemption from the greed tax could be provided for anyone so valuable that they can offer evidence of an assurance that they can "take it with them."

B. Other Policies Affecting Capital Ownership. A variety of government policies impact capital ownership, many of which are outside the jurisdiction of this Committee. For example:

(1) Government Contracts. Require that a portion of capital financings attributable to taxpayer-funded contracts (e.g., defense contracts, government facility service contracts, environmental clean-up contracts, etc.) be financed so as to become partially employee-owned. A government contract, in essence, is a taxpayer-financed asset against which funds can be borrowed to acquire the capital assets (and hire the personnel) to perform under the contract. This approach may also have a positive effect on current efforts to stem fraud, waste and abuse among government contractors.

(2) Government Licensing. Require as a condition of granting government licenses (a type of capital asset) or access to public assets (e.g., drilling/mining rights, asset sales, etc.) that a substantial portion (e.g., 25%) of those taxpayer-granted capital assets become employee owned. Where appropriate, the financing could be assisted by the government accepting a note for the ESOP portion, allowing the employees to acquire their equity interest out of the company's earnings.

(3) Government Loans and Loan Guarantees. Require as a condition that employees of assisted companies be included among those for whom taxpayers provide such capital financing assistance (e.g., by requiring that 25% of the loan or guarantee amount be financed through an ESOP).

(4) Social Security Trust Fund Investments. Require that a portion of the surplus accumulating in the Social Security trust fund be invested in ESOP notes or in the stocks or bonds of companies with ESOPs.[23]

(5) Antitrust Policy. As part of any government-ordered antitrust divestitures, provide a preference for divestitures that are ESOP financed.

(6) Corporate Takeovers. Extend the minimum tender offer period on the tender for companies that have had in place a minimum 10% ESOP for at least six months, allowing additional time for the structuring of a buyout offer that includes the employees (via an ESOP). The Tender Offer Disclosure and Fairness Act of 1987 (approved by the Senate Banking Committee) included this provision.

(7) Utilities Finance. Rather than continuing to pay a guaranteed return to investors throughout a consumer's relationship with a utility, consumers' monthly payments (a utility's only source of cash flow) could be used to gradually convert from investor ownership to a combination of investor, consumer and employee ownership.[24]

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[23] See footnote 11.

[24] The "self financing" of income-producing capital becomes particularly obvious in the financing of utilities, where consumers are required to provide investors with a guaranteed return on their investment. That required cash flow could, over time, be converted into a personal stake in those income-producing assets. Those consumer-owners may choose to forego that capital-based income in return for lower rates. This approach to utilities finance could also help address utilities-related environmental issues by, as economists phrase it, "localizing control over the externalities".

(8) Preferred Federal Reserve Discounting. Where loans for new productive capital are structured to expand capital ownership through ESOP financing, allow the notes of member banks to be discounted at a preferred interest rate and/or offer the originating bank more favorable reserve requirements on such loans.[25]

(9) Privatization. Utilize ESOP financing to enable a substantial portion of privatized companies to become employee-owned (e.g., with the government taking a note for that portion), possibly with the balance being sold to the public. In July 1986, the U.S. Office of Personnel Management announced the Federal Employee Direct Corporate Ownership Opportunity Plan ("FED CO-OP"), a privatization program under which employees would (via ESOPs) become shareholders in companies privatized by the U.S. government.[26]

(10) Government's Spending Leverage. Due to the immense purchasing power of the Federal Government, consideration should be given to directing those purchases to corporations that utilize that cash flow, in part, to create stock ownership for employees. For example, federal employees could be prohibited from receiving travel reimbursements if they stayed at hotels that did not maintain a minimal amount of employee stock ownership. Similarly, government agencies could be directed to use their best efforts to buy their goods and services from ESOP companies.

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[25] See footnote 7.

[26] A bipartisan Presidential Task Force report recommends the use of ESOP financing as a means for privatizing state-owned enterprises in Central America and the Caribbean, particularly in connnection with debt/equity conversions. See High Road to Economic Justice -- U.S. Encouragement of Employee Stock Ownership Plans in Central America and the Caribbean (October 1986).

EXHIBIT A

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OVERVIEW OF ESOP TAX INCENTIVES

1. **Employer Tax Deduction.** Up to 25% of participants' payroll may be deducted from the gross income of an employer to make principal payments on an ESOP loan used to acquire employer securities.

2. **Employee tax deferral.** The annual amount that may be allocated to each employee's account cannot exceed the lesser of 25% or $50,000. Tax is deferred until the account is distributed; the original cost of the shares is then taxed utilizing 5-year averaging if the account balance is distributed as a lump sum after age 59-1/2 on account of separation from service or due to death or disability.

3. **Rollover of gain.** If, after a sale of stock to an ESOP, at least 30% of the stock of a closely-held company is held by the ESOP, tax may be deferred on any gain realized by selling shareholders to the extent that proceeds are reinvested ("rolled over") in securities of other domestic operating companies.

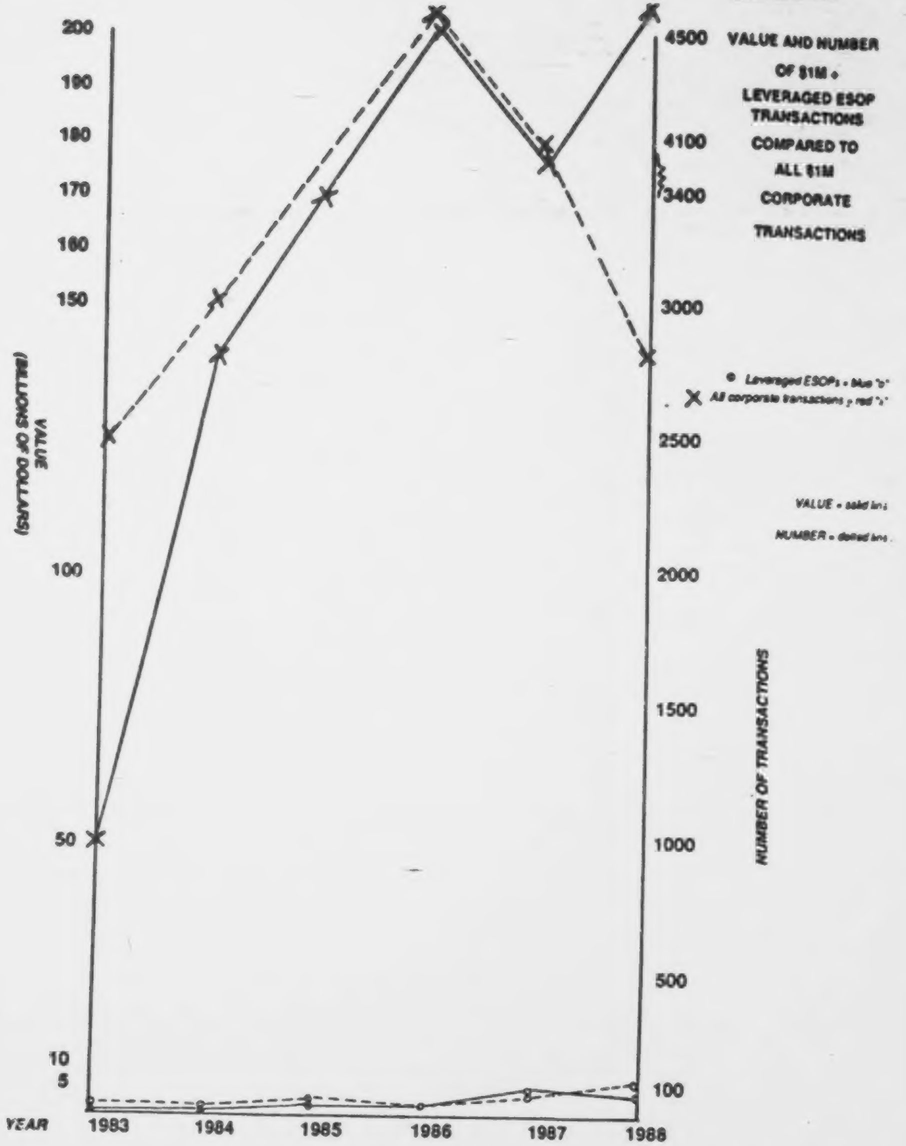
4. **Dividend deduction.** A corporation tax deduction may be claimed for dividends paid on ESOP-held shares to the extent that such dividends are either applied to repay an ESOP loan or paid out to employees on a current basis.

5. **Lender interest exclusion.** Commercial lenders and mutual funds may exclude from taxable income 50% of the interest earned on ESOP loans, thereby enabling lenders to offer lower interest rates for ESOP financing. The exclusion also applies to loans matched by contributions of stock to an ESOP provided the stock is allocated within one year.

6. **Exception to net operating loss limitations.** The limitations otherwise applicable to the use of net operating carryforward deductions following a more than 50% change in ownership are inapplicable to a transaction which results in an ESOP owning at least 50% of the corporation.

7. **Estate tax advantages.** An exclusion from an estate is permitted for up to 50% of the proceeds realized on an estate's sale of stock to an ESOP. The liability for payment of estate taxes may be assumed by an ESOP in return for a transfer from the estate of stock of an equal value, provided the ESOP company guarantees payment of the taxes.

EXHIBIT B



VALUE AND NUMBER
OF $1M +
LEVERAGED ESOP
TRANSACTIONS
COMPARED TO
ALL $1M
CORPORATE
TRANSACTIONS

Source: The Employee Stock Ownership Association

EXHIBIT C

Table 4.1: Assets of All Households and of the Wealthiest Households, 1983

Type of asset	All households amount[a]	Percent of total for Wealthiest Households: Top 0.5%	Top 1%	Top 10%
Trusts	$495.7	77.0%	81.6%	95.1%
Corporate stock[b]	1,035.0	46.5	58.4	89.3
Bonds	339.1	41.3	49.6	88.0
Business assets	2,274.6	39.0	51.6	90.9
Money market accounts	286.0	15.9	22.5	58.8
Real estate	5,366.0	14.9	19.3	49.2
Land contracts	111.0	13.9	15.2	50.4
IRAs and Keoghs	142.2	13.0	21.1	67.3
Checking accounts	115.9	9.7	17.2	46.3
Insurance cash surrender value	256.6	6.7	10.3	34.9
Certificates of deposit	380.1	4.8	10.7	49.9
Savings accounts	189.5	2.1	5.2	31.1
Automobiles	358.5	1.6	3.0	20.1
Miscellaneous	301.1	15.2	22.1	70.2
Gross assets	11,486.4	24.8	31.8	63.8
Net worth	10,036.9	26.7	34.3	67.9

[a] In billions of dollars

[b] Including stock owned directly or through mutual funds but excluding holdings of pension plan trusts

Source: U.S. Congress, Joint Economic Committee, The Concentration of Wealth in the United States: Trends in the Distribution of Wealth among American Families, Washington: Joint Economic Committee, 1986, p. 24. The figures in the table are based on revised estimates provided to us by the Federal Reserve Board following publication of the Joint Economic Committee report.

ESOPS appear to provide a broader distribution of stock ownership than generally prevails (not accounting for pension funds or insurance company holdings). ESOPS are subject to the Internal Revenue Code coverage and nondiscrimination rules applicable to all qualified employee plans. Thus, broad participation in ownership of the sponsoring corporation's stock is a condition for corporate use of tax advantages related to ESOPS. Based on data from the IRS, the median rate of employee participation for all ESOPS is nearly 71 percent. This proportion does not vary much among the types of ESOPS, although the median for tax credit ESOPS, less than 63 percent, is somewhat lower than for other types. Assuming that the employees of firms with ESOPS include workers who differ widely in levels of wealth and income, then the high proportion of these workers participating in stock ownership through ESOPS suggests that these plans do broaden stock ownership within sponsoring firms.

EXHIBIT D

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SOURCES AND USES OF CORPORATE FUNDS

ANNUAL FLOWS

ANNUAL FLOWS

		1965	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987	1988	
1	TOTAL SOURCES	92.7	101.8	155.3	324.8	375.8	298.5	420.3	492.6	459.2	519.8	483.2	468.0	1
2	INTERNAL	59.1	62.8	124.8	200.1	239.5	242.3	285.7	336.3	352.3	357.5	352.8	364.5	2
3	DOMESTIC UNDIST.PROFITS	19.1	7.6	36.4	53.7	50.2	11.6	22.2	41.8	16.7	6.3	16.0	27.0	3
4	IVA AND CCC ADJUSTMENTS	3.9	-1.6	-17.9	-59.2	-30.0	-18.7	5.1	25.1	53.5	36.7	25.7	11.6	4
	CAP.CONS.ALLOWANCES	31.5	49.9	91.9	171.3	190.8	221.4	228.2	238.4	251.0	262.6	274.7	290.6	5
	FGN. EARNINGS 1	4.7	6.9	14.4	34.4	28.5	28.1	30.2	30.9	31.1	51.9	34.4	35.3	6
	'RNAL	33.6	39.0	30.5	124.7	136.4	56.2	134.6	156.3	106.9	162.3	130.4	103.5	7
	'ENT OF TOTAL	36.2	38.3	19.6	38.4	36.3	18.8	32.0	31.7	23.3	31.2	27.0	22.1	8
	'T MKT. FUNDS	18.8	34.1	23.1	70.7	90.7	49.8	77.9	95.8	50.9	121.3	68.9	62.4	9
	.URITIES + MORTGAGES	7.0	26.3	39.4	34.5	29.4	10.3	52.6	-5.1	5.0	59.1	38.6	-19.9	10
	EQUITY ISSUES	*	5.7	9.9	12.9	-11.5	6.4	23.5	-74.5	-81.5	-80.8	-76.5	-130.5	11
	BONDS + MORTGAGES 2	7.1	20.6	29.5	21.6	40.9	3.9	29.1	69.4	86.5	139.8	115.1	110.6	12
	LOANS + S.T. PAPER	11.8	7.8	-16.3	36.2	61.2	39.5	25.3	100.9	46.0	62.3	30.3	82.3	13
	OTHER 3	14.7	4.9	7.4	54.0	45.7	6.4	56.8	60.5	55.9	41.0	61.5	41.1	14
	PROFIT TAXES PAYABLE	2.2	-3.7	-1.3	0.7	-8.2	-12.7	8.0	1.9	1.4	2.5	1.4	-.7	15
	TRADE DEBT	12.2	7.1	6.2	38.0	28.6	5.4	37.3	33.0	34.0	3.1	18.0	-.3	16
	FGN DIRECT INVESTMENT IN	0.4	1.5	2.6	15.3	25.3	13.8	11.5	25.6	20.5	35.4	42.2	42.1	17
.8	TOTAL USES	83.4	97.9	153.4	342.1	383.6	303.5	385.8	502.7	435.3	456.8	437.3	436.7	18
.9	CAPITAL EXPENDITURES	61.6	79.2	112.5	243.7	286.5	256.5	270.7	370.6	342.3	333.9	361.7	395.8	19
0	INCREASE IN FINANCIAL ASSETS	21.8	18.7	41.1	98.4	97.0	47.0	115.1	132.1	93.0	122.8	75.6	40.9	20
1	DISCREPANCY	9.3	3.8	1.9	-17.3	-7.7	-4.9	34.5	-10.1	23.9	63.0	45.9	31.3	21

.) FOREIGN BRANCH PROFITS,DIVIDENDS, AND SUBSIDIARIES' EARNINGS RETAINED ABROAD.

(2) INCLUDES INDUSTRIAL POLLUTION CONTROL REVENUE BONDS ISSUED BY STATE AND LOCAL GOVERNMENTS TO FINANCE PRIVATE INVESTMENT AND SECURED IN INTEREST AND PRINCIPAL BY THE INDUSTRIAL USER OF THE FUNDS.

(3) CONSISTS OF TAX LIABILITIES, TRADE DEBT, AND DIRECT FOREIGN INVESTMENT IN U.S.

Source: Federal Reserve, Flow of Funds Section

Mr. COYNE. Thank you, Mr. Gates. I want to thank all of the panelists for your testimony.

Dr. Needham—and I would like to have the other panelists comment on this question, if you care to—do you think that the proliferation of LBO's in recent years indicate to us that Congress and the administration may need to devise some method for examining LBO's on a case by case basis as to whether they should proceed or not?

Ms. NEEDHAM. I had not thought about a case by case, but that is actually what my colleagues and I are doing right now in trying to sort through which ones seem to be reasonable and which ones seem to be so highly leveraged that they cannot cover their interest. There might be, we suggested the 4 to 1 ratio as an easy test of when they should stop getting tax advantages, because out of less than 2 percent of 1,200 industrial companies listed on value line had debt-equity ratios higher than that. So you might find some screen that would let you sort out. I do not think you would want to examine every single one.

Mr. COYNE. Anyone else care to comment?

Mr. KELSO. I agree with Dr. Needham that there are good leveraged buyouts and there are bad leveraged buyouts. But I would suggest a different test. I would like to call it the funnel test. The non-ESOP or nonbinary LBO takes highly concentrated ownership—this is the restructuring process—and condenses it into even more incredibly concentrated ownership.

To give you the most blatant example of this, there is a family in San Francisco that owns a $2 billion business, sells a retail product very widely used. They restructured the business—it was publicly held—bought all the stock, and they used a non-ESOP funnel leveraged buyout and concentrated the ownership into one family, the family of the founder, about 50 people.

Now I will tell you, and you know this, 50 people cannot consume what $2 billion produces. But if you understand the logic of a market economy as laid out very carefully by Adam Smith, it requires powerful consumers to support powerful producers just as it does vice versa. The moment a family produces 100, 1,000, 5,000 times an affluent income, it will not spend that income in the market for goods and services. In other words, Smith's rule for a market economy does not work if economic power—that is, power to produce goods and services—is not democratically distributed. The non ESOP LBO plutocratizes the ownership of earning power.

Now the policy that has to change can come from nowhere else except this committee and perhaps the Senate Finance Committee, and I believe the odds greatly favor this committee if I may say so.

Ms. NEEDHAM. Mr. Coyne, could I add to your question about how to tell? To some extent we do have under the market system the ability for stockholders to tell if they have adequate information and if they have enough time to digest it. The SEC has just on Monday released request for comments in the Federal Register on a proposed expansion of the type of information that should be disclosed. I would certainly support that.

But I would also add that if stockholders have intelligible, adequate—not necessarily more, but adequate information and the time to do the proper analysis, they could probably pick out some of those good from bad LBO's. Basically they should be picking them out because they are the ones who are selling their stock or their fiduciaries are.

Mr. COYNE. Mr. Courtney.

Mr. COURTNEY. Thank you. I agree with the comment just made that shareholders need to be included in that loop. It is clear that you cannot, at this stage, trust management locked in their boardroom with the ammunition they already have to work in the fiduciary capacity of shareholders.

But with respect to Mr. Kelso's comments, I certainly hope that Congress is not considering—and maybe I misunderstood him—telling us who can earn what in this country. Debt-equity ratios compared historically are not much if any bit higher than they were in the 1970's. LBO's represent capitalism at its very best. If they did not work, the free market would annihilate it, destroy it, and turn out the lights.

Mr. KELSO. May I comment on Mr. Courtney's statement? Nothing that I suggest would involve Government getting involved in trying to influence the rate of return. A free market commands that. But there is a very important difference between debt involved in ESOP's and other binary financing, and it is this. That debt is short term debt, mostly 6, 7 years. From the very moment of the closing of the deal, it starts to turn into equity.

In other words, it becomes savings automatically. You want to boom up savings? That is the way to do it. Out of the $740 billion worth of capital transactions Mr. Gates mentioned, if half those were financed through binary techniques—remember now, the ESOP is the only one legislatively implemented yet, but the others are equally powerful—we could add to the number of capital workers, people who earn their income through capital as well as their labor, 5 million people a year—through just half of the total.

Now that means that in 10 years we would make capital workers out of half the population. Then you would begin to have a system that makes sense under which powerful consumers do support powerful producers.

Mr. COYNE. Mr. Ford.

Mr. FORD. Thank you very much, Mr. Chairman. Dr. Needham, I did not write that company's name down in my hometown. You said the state of Tennessee in my hometown of Memphis, which one of those——

Ms. NEEDHAM. I do not know, but I will find out and tell you.

Mr. FORD. Dr. Needham, what about these ESOP's? Mr. Kelso there has a theory about the working poor and employees and ESOP's and leveraged buyouts. Give me your theory on leveraged buyouts as they relate to employee ownership, being a strong participant maybe in these leveraged buyouts. As we know, we have seen the major leveraged buyouts, we have only had about 2 or 3 percent of those that have had ESOP participation. Do you have any comments in that area?

Ms. NEEDHAM. I think more ESOP participation would indeed be a good thing. But I think the issue gets to whether or not the LBO as structured is sustainable. If it is sustainable, then it is nice that the ownership can redound to employees as well as to a smaller group of managers. But if it is structured in such a way that there is not a long term hope that this deal will make it, then it does not matter if you have the best managers in the world or the best ESOP, you are not going to turn straw into gold.

Mr. **Ford**. So the ESOP's that we have seen in ESOP leveraged buyouts, how do you stack them up against the regular leveraged buyouts that we have seen in recent years?

Ms. **Needham**. Give me an example of one.

Mr. **Ford**. Just any ESOP—maybe Mr. Gates or Mr. Kelso can give us an example of a leveraged buyout ESOP.

Mr. **Kelso**. Congressman, I can get the same comparison, I think, by a reverse twist. If RJR-Nabisco were ESOP financed, which it could be—a lot easier, as a matter of fact, than the deal that existed—you would have about a half million capital owning families who after 6 or 7 years would have paid for that $25 billion asset. You would have $25 billion worth of savings added to the economy, and you would have it democratically diffused instead of having it in a handful of already billionaires, which is what happened. Now that is a regulatory problem of a first order and Congress ought to attend to it.

Mr. **Ford**. Let's use Nabisco. It is not an ESOP LBO, we understand.

Ms. **Needham**. And?

Mr. **Ford**. Just can you comment on that? My concern here has been, as I think the Kelso group is talking about, ESOP participation in these LBO's. It is not that I am taking the position that I am ready to say that we do not need to make some changes in our Tax Code as the LBO's exist today. I know Mr. Courtney has already talked about how the global competition will step in. I am not an advocate of doing away with any of the changes since 1986, but I think we need to revisit the area and make sure that we make some modifications in the area.

But the Kelso group is talking about leveraged buyouts in ESOP's. I guess, let me just move over to the ESOP groups. Mr. Gates, you mentioned earlier about the closed system of finance, and the rich getting richer I would assume. Could you elaborate maybe a little bit more on that? You made reference to your testimony that is before the committee. I have not read your full testimony, but can you elaborate a bit more on the closed system of finance that you talked about?

Mr. **Gates**. Sure, and let me put it in the context of a leveraged buyout. You find that where companies get their funds and why leveraged buyouts work is because, as Mr. Kelso mentioned, productive assets pay for themselves. That is the nature of a market economy.

What you find is that companies raise their money through retained earnings, which they use for growth or for other purposes; through tax benefits, primarily depreciation; and through debt. It is the cash flow of depreciation in large part that enables you to handle that debt. Of course, the interest deductions help as well. There is very little equity being sold. On a net basis, it is now substantially negative.

So really, this committee is somewhat constrained. It can raise or lower the corporate tax rate and have some effect on retained earnings and ownership still remains very concentrated. It can raise and lower depreciation as it has done in 1981 and then backing off in 1984 and 1986, and has little effect on ownership. It just means less cash flow. Alan Greenspan can have more or less impact in raising or lowering interest rates down at the Federal Reserve, and still you have very little effect on ownership.

So what we are suggesting is that what you need to do is when this debt is structured, that there should be enough incentive that that debt will be structured so it economically empowers a broad group of people rather than it currently is structured to benefit a very narrow group. It is clear right now that the ESOP incentives—I am a little embarrassed. I have been at this 16 years and last year of the over $300 billion that was ownership transfers or mergers or acquisitions, less than $5 billion of that went into ESOP's. That is embarrassing.

So obviously the incentives are not generous enough, they are not rich enough. The differential between conventional finance and ESOP finance is not yet sufficient to make it attractive.

Mr. FORD. But Mr. Gates, we have had other witnesses who have testified before this committee in recent weeks, and some critics of ESOP's claim that the ESOP incentives are in fact too generous. If that is the case, why have we not seen more than that 3 percent that you are talking about of ESOP participation in these LBO's?

Mr. GATES. They are obviously not familiar with the facts, for one. But I think you find that, one, ESOP's are complicated, of course.

Two, the margin between using an ESOP and using conventional finance is—for example, if we do an LBO and we can repay the debt in 5 to 6 years, if you include a leveraged ESOP, if you look through all the bells and whistles of ESOP incentives what it is about is enhanced cash-flow to the employer through a number of different means. That means I can service that debt, instead of over 5 years, maybe in 4½ years, which is about the differential. But to do that I have to give up some equity, a difficult task if I am the person who could otherwise structure the deal to buy the equity for me.

In addition, if it is a closely held company I also build in a liability. Also ESOP law changes year after year after year up here and views change about how ESOP's are going to be treated. Some people have a view as to different things that the ESOP concept is intended to accomplish. We also have a regulatory problem down at the Department of Labor where they have been very unrealistic in what ESOP's do in fact bring to a transaction.

Then there is just straight old greed. I mean, why should I, being an LBO structurer, include an ESOP? Why should I not structure it all for myself? We happen to believe that you should do that for a number of reasons, and Mr. Kelso has touched on them. But others do not share that view.

Mr. FORD. Mr. Chairman, I have one final question if you would——

Mr. HICKMAN. Mr. Ford, could I make just a comment on your observation? It is not necessarily the leveraged buyout itself that you should look at to find ESOP's. Watching things from the legal sidelines, I have seen a wholesale creation of ESOP's in the last couple of years far beyond what had taken place in earlier years, in large part as a management defensive tactic against LBO takeovers. So my impression, at least from the sidelines, is that the existence of the LBO movement has done more to provide incentives for managements to set up ESOP's than anything so far, including the tax benefits accorded ESOP's.

Mr. **Kelso**. Mr. Ford, I would like to put in the record just this comment. Yes, ESOP's which build ownership into friends instead of strangers, friends of the company, employees, are a good anti-takeover weapon. But the importance of democratizing economic power is greater, infinitely greater today than democratizing political power. We have already pretty well accomplished that. The thrust of congressional efforts to bring that about, I think, is absolutely essential to begin to make the economy work again.

Over half of all the taxes collected go to support transfer payments. Why do we have transfer payments? Because a lot of people cannot earn a living. A lot of working people cannot earn a living. A lot of people who want to work cannot have jobs or are not able to have them. We can build capital ownership into anyone with those eight tools. It is high time we begin to make sense out of the economy. The national economic policy is wrong.

Mr. **Ford**. Is that an answer? Would employee stock ownership prevent some of these takeovers or rather leveraged buyouts? I am asking Mr. Hickman.

Mr. **Kelso**. Congress should discourage any LBO's which do not include an element of democratizing the economic power. You could set up—this is not a definitive answer, but you could set up a provision in the tax code that would say that if a restructuring is $5 million or more, 10 percent or 20 percent should be financed through binary techniques, the ESOP or others. If it is $20 million—more. If it is $50 million—more.

When it gets to the size of an RJR-Nabisco, it ought to hit 90 percent. Everybody comes out the same except those who are abusing the system. Namely, acquiring earning power that they cannot use legitimately, they can only use it to acquire more capital, and that they cannot take with them.

Now this is insane. By the way, it is a straight violation of the common law of private property. Our book which we left with you, Democracy and Economic Power, makes, I think, an unshakeable case for that.

Mr. **Ford**. Mr. Kelso, in your testimony you refer to the need to change the national economic policy to include widespread capital ownership as a specific economic goal. Why is not full employment itself a sufficient economic goal under the theory that you use?

Mr. **Kelso**. Because of labor—that is Adam Smith's mistake. He was looking at the industrial revolution through the wrong end of the telescope. Labor is only one of the ways to engage in production. The ownership of capital is another way. My estimate is that 90 percent of the goods and services are produced by people who work through their capital, and only 10 percent by people who work through labor. Now that shows you how much redistribution we are suffering hour by hour. That means the system is running at a fraction of the speed that it would run.

Incidentally, this is not Kelso's idea any longer. After lengthy testimony before the Joint Economic Committee, which is the think tank of Congress itself, in 1975—in the annual report for 1975 which came out in January 1976, the Joint Economic Committee recommended a change in economic policy. That is the committee's own recommendation.

So the thinking has already been done. But it has not been paid attention to. Unfortunately, the Joint Economic Committee cannot introduce legislation. Even worse, it cannot even lobby although I guess the individuals could. Senator Russell Long was a guest on that committee.

Mr. FORD. The staff director of the Subcommittee on Human Resources has indicated that you have requested to testify before the Public Assistance Subcommittee. We certainly will look forward to your testimony because you want to talk about the working poor.

Mr. KELSO. Yes, sir.

Mr. FORD. If there is any way that you can tell us how we can incorporate employees who are the working poor in this country and make them as a major player in some of these leveraged buyouts, you are going to have my support on this committee. It is time now that the employees and the working poor enjoy a piece of that economic pie in this country.

Mr. KELSO. I will do it. We can make capital workers out of anybody. We can make capital workers out of a wooden Indian if you could think of any reason to do that.

Mr. COURTNEY. Mr. Ford, there is an important variable that I think Mr. Kelso is leaving out of the formula. That is the $20 billion of shareholder premiums that were paid in LBO's from 1980 to 1987 which does not include, clearly, calendar year 1988.

Mr. FORD. What was the dollar amount again?

Mr. COURTNEY. $20 billion just in premiums paid up through 1987. That does not include RJR-Nabisco and anything else that happened in 1988 for which I do not have a figure for. But that other side of the formula is an important point to balancing what Mr. Kelso's theory is advancing, which is basically redistribution of the wealth. Let us go down to where RJR is headquartered in North Carolina and talk to the people in that town that were employees of that company. I do not think they have any problem having received their $200-, $300-, $400-, $500,000 checks, $1 million distributions from working at this company for a period of time.

Mr. FORD. Is that the top corporate people or are you talking about the rank and file?

Mr. COURTNEY. I am talking about the rank and file, sir.

Mr. FORD. They received what kind of money?

Mr. COURTNEY. I have read reports of people who have worked at RJR Nabisco 15 to 25 years receiving $1 million checks on this.

Mr. KELSO. Where did it come from? In other words, how did they get stock worth that?

Mr. HICKMAN. They saved their money and invested it.

Mr. COURTNEY. Over a period of time, working at the company, they invested their money in RJR, subsequently RJR-Nabisco, and cashed out with the KKR proposal.

Mr. KELSO. It could happen with management. But I will tell you this, 200 years of saving, belt-tightening and investing leaves 100 percent of the non-residential capital in the U.S. economy in the top 5 percent. I say that is manifest evidence that it does not work.

If it does not work in two centuries, it is not going to work in two more, and we are not going to be around here that long.

Mr. **Ford**. Thank you very much. Mr. Chairman, thank you very much for allowing me the time.

Mr. **Coyne**. We appreciate the testimony of the panelists, the witnesses. The meeting is adjourned. Thank you.

[Whereupon, at 1:10 p.m., the hearing was concluded.]

[Submissions for the record follows:]

Federal Home Loan Bank Board
OFFICE OF THE CHAIRMAN

M. DANNY WALL, Chairman

1700 G Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

February 22, 1989

Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Dear Mr. Chairman:

The Federal Home Loan Bank Board shares the concerns the Congress has expressed over the proliferation of leveraged buyouts ("LBOs") and is pleased to have this opportunity to let the Congress know what steps the Board has taken to ensure that any thrift participation in buyouts is legal, prudent, safe, and sound.

The Board has found that thrift participation in LBO financing is limited. We believe we have already instituted sufficient safeguards through regulation, guidelines and examination procedures to satisfactorily govern a thrift's involvement in such transactions. We are, however, prepared to do more should activity in this area increase or should current monitoring indicate more stringent safeguards are necessary.

INVESTMENT LIMITATIONS

Institutions insured by the Federal Savings and Loan Insurance Corporation are authorized to invest in commercial loans and below-investment-grade securities (junk bonds), the categories into which leveraged buyout financing would fall. Federal regulations impose a commercial loan investment restriction of 10 percent of assets on federally-chartered thrifts. Junk bonds are also included in that investment restriction. An additional one percent of assets may be invested in commercial paper or corporate debt securities (credit ratings notwithstanding). The investment authority of state-chartered thrifts in commercial loans and junk bonds is dependent on state laws and regulations and subject to the Board's safety and soundness considerations.

All corporate debt securities are subject to the commercial loans-to-one-borrower limitations of Insurance Regulation 563.9-3 which limits the extension of commercial credit to any one borrower to 15 percent of the thrift's unimpaired capital and surplus.

Although Federal institutions are prohibited from investing in equity securities, some state-chartered institutions are able to do so under state law. The amount of such investment, however, is limited by our Equity Risk Investment rule (Insurance Regulation 563.9-8), which prohibits such investments by institutions that fail their regulatory capital requirement unless they receive the express approval of their supervisory agent. Institutions with tangible capital that exceeds six percent of liabilities are restricted to an investment no greater than three times tangible capital for all equity risk investments.

Additional safeguards will commence with the adoption of the Board's proposed risk-based capital rule. Commercial loans and junk bonds will be subject to a capital requirement that is at least twice as stringent as that for home mortgage loans and other low risk investments; equity securities will be subject to an even stricter standard.

GUIDELINES

LBO financing, while providing some income opportunities for depository institutions, may be high risk and as such requires institutions to have a high level of financial and managerial expertise. To help assure that institutions have this expertise before engaging in LBO financing, the Board has issued to examiners, supervisory staff, and all FSLIC-insured institutions, guidelines on commercial lending and investment in junk bonds.

The commercial loan guidelines were issued in the form of a regulatory memorandum in July of 1985. In response to the proliferation of more complex transactions and the increasing prominence of junk bond investments, the guidelines were revised and reissued in June of 1988.

The guidelines impose safe and sound standards for commercial loan investments. Management must implement a sound underwriting policy to guide staff and to ensure prudent risk-taking. While an institution must develop a policy appropriate to its own operations, it must contain certain critical components, including: the delegation of underwriting, lending, and investment authorities and responsibilities; the composition and responsibilities of the loan and investment committees; a framework for pricing decisions; specific underwriting criteria; and loan analysis procedures.

Although junk bonds are addressed in the commercial loan memorandum, the Board believed that their different characteristics warranted separate underwriting guidelines. As a result, the Board issued a policy guidance bulletin separately addressing investment in below-investment-grade corporate debt securities in January of this year.

These guidelines provide a minimum framework for a safe and sound junk bond investment program and specifically restrict the investment authority of thrifts with inadequate capital. The bulletin charges a thrift's board of directors with the establishment, adoption, maintenance and administration of a written investment policy. The policy must cover underwriting policies and procedures, delegation of decision-making authorities and responsibilities, the retention of qualified staff or consultants, and the establishment of specific investment standards. The bulletin also provides guidelines for diversification and underwriting standards.

In addition to these two memoranda, the Board's Office of Regulatory Activities has recently issued a Thrift Activities Handbook that explains what examiners should review and how they should conduct that review. The Asset Quality Section of the Handbook contains chapters on Lending Risk Assessment, Other Commercial Lending, Investment Securities, Equity Risk Investments, and Classification of Assets, all topics pertinent to the review of LBO financing.

Bank Board staff has reviewed the examination circular entitled "Highly Leveraged Transactions" issued by the Office of the Comptroller of the Currency last month. The Board believes that the substance of the guidelines proffered by the OCC is contained in the guidance (described above) that we have already issued to the thrift industry and to our own examiners and supervisory staff.

For example, the Handbook chapter on "Investment Securities", explains the principles of safety and soundness, portfolio management objectives, strategies to implement policy objectives, and management responsibilities. It describes credit risk, defines investment quality and subinvestment quality, discusses traditional investment securities, high yield bonds, money market instruments, mortgage-backed securities and other securities. Accounting requirements are noted and a glossary of terms is provided.

The Handbook prescribes appropriate examination procedures that are separated into levels. More intensive examinations are undertaken if the thrift is very active in investment securities or if "red flags", disclosed in the first level review, make clear the need for a more expansive, in-depth analysis.

We believe the Handbook chapters pertinent to LBO transactions, in conjunction with our separately-issued memoranda on commercial loans and junk bonds, fully encompass the OCC guidance. We will, nevertheless, continue to monitor developments carefully and are prepared to either revise our policies and procedures or act on a case-by-case basis if such actions are warranted.

SURVEY

A recent survey of thrift involvement in LBO financing suggests no need to issue additional guidance at this time. Our District Banks were asked about the extent of LBO financing by thrifts, the adequacy of underwriting, and whether training and examination procedures should be enhanced in light of this relatively new form of commercial lending.

The results of the survey indicated that, to date, LBO financing is limited to a small number of thrifts. Of those, involvement is usually through investment in junk bonds. Underwriting has been generally good with only a few exceptions where basic underwriting policies and procedures were not in place. These deficiencies are being corrected under the oversight of the regional supervisory officials.

While not yet a particularly active area for thrift investment and so not a major examination concern at this time, indications from the field are that specialized training in this area would be welcome. The Board has already begun to address this need with a planned nationwide seminar on junk bonds.

As you are aware, one thrift institution that is likely to engage in LBO financing is American Savings and Loan. A condition of its acquisition by Robert M. Bass and Associates provides that a subsidiary of the association will be permitted to engage in the purchase of equity securities. Both the association and its subsidiary, however, will be subject to the same prescribed dollar investment limitations imposed on all institutions insured by the FSLIC. In addition, as a federally-chartered institution, American may only invest two percent of its assets in all of its subsidiaries. Of all the regulatory limitations, this is the most restrictive in curtailing the transactions of American's subsidiary.

In addition to normal supervisory restrictions and regulations, the FSLIC and the Bass group have entered into an agreement prohibiting the subsidiary from engaging or investing in certain activities: it restricts the dollar amount of the association's exposure to any one entity held by the subsidiary, whether through equity investments or commercial loans. It limits the aggregate debt, investment, extensions of credit or commitments of the subsidiary, and it provides for a process whereby the subsidiary is subject to a quarterly mark-to-market analysis of its assets. This "market value" test of the subsidiary's assets will provide us, as regulators, a more sensitive determination of the real economic value of the assets than could be determined solely from using Generally Accepted Accounting Principles.

CONCLUSION

The Bank Board appreciates the opportunity to comment on LBO financing and believes the Congressional review of LBOs represents an important step in understanding the impact of such transactions. We commend the Congress for its efforts to achieve reform where necessary in this area and for its willingness to hear from those who share its concerns.

Sincerely,

M. Danny Wall
Chairman

cc: Board Member Martin
Board Member White

Garrity & Spangler, Ltd.
518 South Eighth Street
Lebanon, Pennsylvania 17042

February 3, 1989

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Congressional hearings regarding mergers, acquisitions and leveraged buy-outs ("LBO" 's)

Dear Mr. Leonard:

I am writing to propose a relatively simple approach toward resolving the current controversy involving tax deductibility of interest expense on corporate LBO debt.

Before I proceed, let me briefly introduce myself so that you will understand my perspective on this issue. I am a CPA and attorney in public accounting practice with a local CPA firm in Lebanon, Pennsylvania. I have specialized in taxation for about twelve years, having worked four years from 1976 to 1980 with a Big Eight accounting firm in Philadelphia and six years from 1980 to 1986 with a dental products manufacturer in York, Pennsylvania. While not currently serving any S.E.C. clients, I worked within the S.E.C. environment in earlier years. My employer in York was an S.E.C. corporation until it went private in a management-led LBO in 1981. While not involved with clients of the size that are currently attracting your attention in the LBO area, I, nevertheless, actively practice in the area of corporate taxation and am much concerned both professionally and personally with our nation's economic vitality.

Since I am not intimately familiar with the discussions and results of your proceedings to date, I do not know what specific proposals you may have already considered. I do know that you are weighing the possibility of denying LBO interest deductions against the possibility of allowing deductions for corporate dividend payments.

At the risk of being considered either redundant or superficial, let me propose that you disallow LBO interest deductions at the corporate level but allow LBO interest to pass-through to corporate shareholders (a hybrid S-corp. concept), allowing shareholders to deduct the interest as portfolio interest, limited to portfolio income. The only conceptual departure from current tax law required here is the introduction of the pass-through concept into the C-corporation environment.

I believe that this approach would have the desirable effect of slowing down the interest deductions currently being taken without limitation by "taxable" corporations, since such deductions would become subject to limitation at the shareholder level. Furthermore, investors/shareholders would collectively be forced to exercise some discretion in deciding whether to accept LBO offers. Also, such a framework might in effect achieve a matching of portfolio expense against portfolio income in that a significant portion of LBO-company shareholders may not be able to deduct their LBO interest until they reap their LBO windfall upon disposition of their shareholdings.

While the form of this proposal is rather broad and lacking in the fully-considered details necessary to draft appropriate legislation, I am hopeful that the concept may have sufficient appeal to merit further consideration by the Ways and Means Committee.

Very respectfully,

Dale A. Achenbach

Dale A. Achenbach

March 15, 1989

STATEMENT OF
GILBERT BUTLER, PRESIDENT
BUTLER CAPITAL CORPORATION
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am the President of Butler Capital Corporation (BCC), a firm that has been engaged since 1981 in structuring and financing management leveraged buyouts, primarily of small to medium sized companies. Prior to organizing BCC, I served as President of Term Capital Management Company and as a Vice President of Morgan Guaranty Trust Company. For over twenty years I have been involved in leveraged buyouts, credit evaluation, and analysis of public and private securities.

I am pleased to have this opportunity to express my views with respect to the recent increase in leveraged buyouts (LBOs). I will describe the activities of Butler Capital Corporation, discuss several concerns that have been raised with respect to LBOs, and comment briefly on some of the recent proposals for changes in the tax law.

I believe my testimony will demonstrate that responsibly structured LBOs -- and particularly those of small to medium sized companies -- serve a valuable function in our economy and should not be discouraged.

I. Description of BCC

BCC specializes in structuring and financing "management leveraged buyouts," transactions in which existing management of a company acquires a significant ownership interest. Four investment funds managed by BCC provide the financing for these transactions. During the past ten years these funds have invested over $750 million in 30 management buyout transactions, every one of which was developed with the full support of existing management and shareholders. These investments were not made because the company was put "in play" by someone seeking arbitrage profits, but often for the simple reason that the retiring company founder sought to sell his stock in a manner that would provide him the best price and would also help ensure the long-term success of the company. As is discussed in greater detail below, these companies have flourished during the period following the management buyout, demonstrated by significant increases in operating profits, employment, and long-term spending for capital improvements.

A typical management buyout sponsored by BCC involves the purchase of a privately held company, a relatively small publicly traded company, or a division or subsidiary of a larger company. One or more BCC funds provide capital through the purchase of senior and subordinated debt and, together with the active managers of the business, common stock in the company. Because BCC has the ability to provide complete financing for a transaction, it can structure a financial package tailored to the needs and resources of a particular company. The company's debt, for example, is carefully structured as to both interest rate and payment schedule in order for the company to have sufficient retained capital both for business expansion and to protect against an unanticipated drop in revenue. The capital provided by the

BCC funds is used both for the acquisition of the stock of the selling shareholders and for the expansion of business operations.

A management buyout creates a powerful incentive for managers to operate a company in the most economically efficient and productive manner. When managers have a substantial amount of their own net worth invested in a company, they are far more likely to run the company in the most profitable manner possible than if they had little or no ownership interest. This incentive effect has been demonstrated time and again by the companies in which BCC has invested. Wasteful, inefficient spending is cut and spending for the long-term success of the companies, such as for capital improvements, is increased. The average increase in annual capital expenditures by the BCC portfolio companies following the management buyouts was 65 percent (computed on an aggregate basis) compared to the three years preceding the buyouts. An example illustrates this trend. Central Tractor Farm and Family Center, Inc., a Des Moines-based retailer of farm supplies and used tractor parts, received a cash infusion upon its BCC-sponsored management buyout in March, 1988. By expanding its operations into seven new communities, Central Tractor recorded a healthy 19 percent increase in sales and a 27 percent increase in profitability in the fiscal year following the transaction. Simply put, long-term investments in machinery, equipment, and buildings make good business sense when structured to increase operating efficiency. A management buyout of the type sponsored by BCC helps foster such investments.

There are, of course, alternatives to a management buyout for controlling shareholders to dispose of their stock. These alternatives rarely include equally effective incentives for existing management, however, and raise other concerns as well. Two such options include sale of the company to either a domestic corporate acquirer or to a foreign acquirer. The first option, acquisition by a larger corporation, will usually not permit the management of the acquired company to have a substantial ownership interest in the company. Thus, the important incentives created by having managers own an entrepreneurial stake in the company are lost. The second option, a sale to a foreign acquirer, often shares the same deficiencies as a sale to a corporate acquirer and also presents the broader problems inherent in foreign ownership of U.S. businesses. Neither of these options permit small- to medium-sized companies, which are a vital source of innovation and competition in our economy, to remain independent. The level of productivity of the BCC portfolio companies is significantly higher than the national average--a testimony to the incentive effect of stock ownership by management. The average operating return on net assets of the portfolio companies, for example, is 32.8 percent, which is at least 50 percent higher than the national average for industrial companies. If Congress were to discourage management buyouts, and hence encourage acquisitions by larger corporations or by foreign acquirers, productivity of similar companies could be expected to drift downward to the national average, thus harming U.S. competitiveness in the world economy.

Another alternative for shareholders seeking to sell a company is a public offering of stock. This is not an attractive alternative, however, for the shareholders of many privately held companies. The market for initial public offerings has continued to be depressed since the October, 1987 market break and often does not offer an opportunity for selling shareholders to realize full value on their stock. In addition, the kinds of companies in which BCC invests are in basic manufacturing industries that are often disfavored by investment bankers seeking to underwrite stock offerings in more "glamorous" areas such as high technology. Management buyouts, such as those structured by BCC, are thus an important source of capital for facilitating the transfer of ownership of a privately held company and in many cases will be the only source that will permit the selling shareholder to receive a fair price.

In sum, a responsibly structured management buyout, one that gives existing management a significant equity stake and that does not place an excessive cash drain on the company, has a number of benefits. It provides incentives for efficient management, allows a company to remain independent, keeps ownership in U.S. hands, and produces a fair price for selling shareholders.

II. Criticism of LBOs

A. Excessive transaction fees

A commonly voiced concern with respect to LBOs is that those who structure such transactions are primarily interested in short-term gain from transactions fees and arbitrage profits. This concern does not apply to the LBOs structured by BCC or by many other responsible LBO funds. Like most investment advisors, BCC receives a fee for managing its investment funds, based on the amount of capital under management. This fee is designed to cover salaries, office rent, and other overhead expenses, and is the only fee received by BCC. In addition, the BCC investment professionals share in the profitability of the BCC portfolio, thus giving them a direct incentive to work towards the long-term success of the portfolio companies.

Neither the management fee received by BCC nor the profit share received by BCC professionals is tied to the number of transactions completed. Notwithstanding the current perception of enormous fees involved in some LBOs, BCC does not charge investment banking, placement, commitment or other transactional fees, and hence has no incentive to enter into any acquisition that does not meet its stringent standards for potential growth combined with minimal risk. Reflecting its disciplined approach to investing, BCC has stayed out of the marketplace when conditions were such that these standards could not be met. Moreover, BCC spends a tremendous amount of time and effort in evaluating potential acquisitions. In 1988 BCC invested in only nine companies out of more than 650 potential transactions that were reviewed. BCC's profits are thus not created by engaging in any kind of financial gimmickry. Instead, they are generated by carefully analyzing prospective investments and by working closely with the owner-managers of a company after an acquisition in order to improve efficiency and to increase operating profits.

B. Excessive debt

Another concern with respect to LBOs is that the acquired companies take on an excessive debt load and will be unable to withstand a downturn in the economy or even a temporary drop in earnings. Although the companies in which the BCC funds have invested have a considerably higher amount of debt after the transaction than before, they have historical earnings and cash flow sufficient to support comfortably the additional debt. BCC and other responsible LBO sponsors avoid companies with an unproven financial record, but instead invest in companies with a long record of steady profits during periods of both expansion and recession in the U.S. economy. In addition, as described above, the buyout debt is carefully structured to allow adequate cash flow not only for payments on the debt but for expansion of the business as well. BCC's conservative approach to debt is demonstrated by the fact that its portfolio companies have never missed or deferred a single interest or principal payment during the ten year history of the portfolio.

C. Short-term perspective

A third concern voiced with respect to certain recent LBOs is that the pressure of debt repayment forces the managers of the acquired companies to take a short-term view of managing the company. Hence profitable divisions are sold off, plants are closed, employees are fired, and capital expenditures drop. Again, BCC's experience demonstrates that these concerns do not apply to responsibly structured management buyouts in which the debt level is not excessive and in which owner-managers are given an incentive for long-term success. There has been, for example, an average 30 percent increase in the number of communities in which the BCC portfolio companies maintain operations following the management buyout and virtually all senior management have continued with the companies after the buyout. Statistics regarding capital spending, employment, revenues and operating profits demonstrate clearly that the companies in which BCC has invested have been managed during the period following the buyout with an eye towards long-term growth and profitability:

Description	Average Increase During Period Following Buyout[1]
Capital Spending[2]	+ 65%
Employment	+ 47%
Revenues	+ 57%
Operating Profit	+ 59%

As the foregoing figures illustrate, BCC concentrates on the long-term growth and success of the companies in which it has invested, working closely with the owner managers. An example, the Frey Scientific Company, comes to mind. Located in Mansfield, Ohio, Frey is a nationwide catalog distributor of educational science supplies. Upon acquiring a significant ownership interest in the company, Frey's management acquired new product lines and greatly expanded its distribution facility to improve service and lower costs. Today, three years after the management buyout, Frey Scientific has approximately quadrupled its revenues and more than doubled its operating profits as a result of these actions.

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[1] These statistics are broken down in greater detail in Exhibits A and B. Length of period following buyout differs according to dates of acquisitions.

[2] Computed on an aggregate basis. Average increase equals 104%.

BCC closely monitors the operations of its portfolio companies and is generally represented on the board of directors and participates in management at the policy level. It has frequent meetings with top and middle level managers with respect to issues such as budgeting, strategic decisions, long-term planning, hiring additional management personnel, and management compensation. Finally, and most importantly, BCC recognizes that the best formula for the long-term success of a company is to have a group of top managers that have a significant ownership interest in the company and hence have a powerful incentive for efficient management.

To summarize my response to the criticism of LBOs, I believe that BCC and many other investors in management leveraged buyouts of privately held companies serve an important function in our economy that should not be discouraged because of a few widely publicized excesses. By providing capital to facilitate a transition of ownership of a company, and by doing so in a responsible manner that encourages improved productivity, such investors create needed liquidity and positive incentives for growth.

III. Proposed Revisions to the Tax Law

Because payment of a dividend is not deductible by a corporation while the payment of interest is, our tax system is biased in favor of debt financing. A number of proposals have been put forward recently that would address, either very broadly or in a targeted manner, this disparate treatment of debt and stock investments. These proposals include a fully or partially "integrated" corporate and individual tax system, disallowance of a deduction for some portion of interest payments on debt (such as payments in excess of a stated rate or payments in excess of a specified debt/equity ratio), and disallowance of debt used to finance a specified activity (such as a corporate acquisition). Although I will not attempt to comment in any detail on these proposals, I would like to make several general observations with respect to them.

Because of our tax system's bias in favor of debt financing by corporations, many government officials and academic commentators have suggested that some form of integration of the corporate and individual tax systems should be adopted, such as a corporate dividends paid deduction or a shareholder credit for taxes paid at the corporate level. An integrated tax system has much to recommend it. First, many of our foreign trading partners provide some relief from the double taxation of corporate earnings. Second, such a change could remove the perennially difficult problem of distinguishing "debt" from "equity" and would allow corporations to raise capital in the most economically efficient, rather than the most tax efficient, manner. Finally, an integrated system would remove the current tax disincentive to operating a business in corporate form.

While the benefits of an integrated tax system are substantial, there are also serious obstacles to the adoption of such a system, the greatest being the significant revenue loss that could result from such a change. Although some form of partial integration would be helpful, such as a deduction for a percentage of dividends paid, this could also prove to be costly and would leave the infirmities of the present system largely intact. In addition, the proposal to "pay" for partial integration by means of limiting the deductibility of interest (in effect making equity a little more attractive and debt a little less so) is not in my opinion a wise course of action. A general restriction on interest deductibility could have far-reaching adverse consequences to the capital markets by effectively increasing the cost of borrowed capital. Restrictions on interest deductibility would also create an advantage for potential foreign acquirers of U.S. companies who can borrow abroad and enjoy full deductibility of interest.

Finally, some integration proposals are flawed in that they would place the burden of paying for integration largely on pension funds and charitable organizations. Under one model, for example, the interest deduction for corporations would be disallowed and a non-refundable tax credit would be allowed for recipients of interest as well as dividends. Such a system would constitute an indirect tax on tax-exempt entities that would ultimately be paid by the beneficiaries of pension funds and of charitable organizations. Although integration of the corporate and individual tax systems is a desirable goal, I do not believe it should be achieved at the expense of charities and pension funds, nor, as indicated above, by increasing the cost of borrowed capital.

Instead of moving towards an integrated tax system, a number of proposals would attempt to shore up the present system of a double tax on corporate earnings. Some proposals would disallow all or a part of the interest deduction for corporate debt that is deemed to have certain equity characteristics. For example, it has been suggested that interest on debt that exceeds a specified debt/equity ratio or a specified interest rate should not be deductible. These proposals also present serious difficulties. A proposal keyed to debt/equity ratios presents practical problems such as the need to take into account the historical differences among industries, the fact that debt/equity ratios fluctuate significantly according to business cycles, and the need to develop a means for classifying the numerous businesses that do not fit neatly into a particular industry. More fundamentally, any effort on the part of the federal government to establish mechanical debt-equity ratios would deprive both the industrial and financial markets of needed flexibility. A rule based on a specified interest rate, whether floating or fixed, also presents similar problems in that such a rule could not accurately reflect the numerous variables that determine the cost of capital for a particular company. Such an approach could seriously disadvantage small start-up companies and those in high risk industries.

Finally, some tax proposals would limit the deductibility of interest only for certain transactions such as acquisitions of another corporation's stock or assets. Such proposals fail to recognize that management leveraged buyouts often perform a desirable function in our economy, and, in addition, are only a relatively small part of the overall trend by corporations towards debt financing. It would be unwise to respond to the criticism of a handful of large LBOs by enacting legislation that would discourage *all* LBOs and encourage foreign and corporate acquisitions at the expense of acquisitions by managers.

Any legislation specifically targeted at LBOs should take into account the beneficial effect of the relatively small, non-hostile, management LBOs sponsored by firms such as BCC. Section 279 of the Internal Revenue Code, for example, which limits the deductibility of interest on certain acquisition debt incurred by corporations, generally applies only to interest in excess of $5,000,000. In 1987, the House passed a bill that contained a new section 279A, that would have further restricted the deductibility of interest on acquisition debt, and again the first $5 million of interest paid was unaffected. Any new legislation considered at this time should have an exception for small or medium sized transactions (a number of which could involve interest expense in excess of $5,000,000) that do not raise the same issues as much larger transactions. I would emphasize, however, that many of the positive effects of small LBOs are also present in larger transactions and Congress should not seek to restrict transactions that facilitate increased productivity and competitiveness of American industry.

IV. Conclusion

I believe that BCC, and similar firms, serve as an important source of capital that enables relatively small companies to facilitate a transfer of ownership and to expand business operations. By working closely with the owner-managers of the companies in which it invests, BCC helps these companies to increase productivity, increase employment, and to plan for the future. Any legislative action taken by Congress should recognize these important functions and should not attempt to discourage them.

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BUTLER CAPITAL CORPORATION

EXHIBIT A

Average Increases in Revenues, Operating Income, and Capital Expenditures Following Management Buyout

Company and Date Acquired	Revenues	Operating Income	Capital Expenditures
Golden State Foods September 1980	92%	140%	224%
Williamhouse-Regency(a) December 1982	57%	30%	24%
Ithaca Industries October 1983	57%	85%	134%
Pannill Knitting(a) April 1984	56%	57%	49%
Frey Scientific(a) August 1985	279%	208%	832%
SunMedia June 1986	10%	4%	N/A
Julius Koch November 1986	(2)%	(3)%	(63)%
First State Envelope December 1986	59%	16%	57%
Present Company October 1987	26%	35%	18%
Silvestri Corp. October 1987	49%	87%	50%
Lancaster Press December 1987	24%	20%	(45)%
Strine Printing(a) January 1988	34%	39%	34%
Central Tractor March 1988	40%	72%	83%
Arcon Coating Mills(a) June 1988	22%	19%	(50)%
Extrusion Dies October 1988	N/A	N/A	N/A
Steel Heddle December 1988	N/A	N/A	N/A
Totals(b)	57% Average Company Increase	59% Average Company Increase	104% Average Company Increase
	62% Aggregate Increase	60% Aggregate Increase	65% Aggregate Increase

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N.B. Data prior to transaction are the average of the preceding three years. Data subsequent to transaction are the average of all succeeding years. Operating income excludes merger-related items. When a transaction occurred during a fiscal year, the year's data were counted according to whether most of the year elapsed before or after the transaction closing date.

(a) Change of fiscal year occurred.

(b) Excludes new transactions, Steel Heddle and Extrusion Dies.

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BUTLER CAPITAL CORPORATION

EXHIBIT B

EMPLOYMENT GROWTH IN PORTFOLIO COMPANIES

Company and Date Acquired	Time Period	Number of Employees, Time of Acquisition	Number of Employees at Recent Date	Percent Increase	Percent Increase, Annualized
Golden State Foods September 1980	7/80-12/88	924	1,703	84%	10%
Williamhouse-Regency December 1982	12/82-12/88	3,245	4,001	23%	4%
Ithaca Industries October 1983	10/83-11/88	5,186	6,960	34%	7%
Pannill Knitting April 1984	04/84-12/88	3,400	5,106	50%	11%
Frey Scientific August 1985	08/85-12/88	83	350	322%	99%
SunMedia June 1986	05/86-12/88	N/A	N/A	N/A	N/A
Julius Koch November 1986	11/86-12/88	134	127	(5)%	(3)%
First State Envelope December 1986	10/86-10/88	265	335	26%	13%
Present Company October 1987	12/87-12/88	1,453	1,642	13%	13%
Silvestri October 1987	10/87-12/88	316	380	20%	16%
Lancaster Press December 1987	09/87-09/88	494	547	11%	11%
Strine Printing January 1988	12/87-12/88	166	180	8%	8%
Central Tractor March 1988	01/88-12/88	900	1,050	17%	17%
Arcon Coating Mills June 1988	06/88-12/88	25	28	12%	24%
Total		16,600	22,409	47% Average Company Increase (Total)	18% Average Company Increase (Annual)

Aggregate Increase: 35%

Note: Extrusion Dies, Inc., acquired in October, 1988, has added one person to its staff of 114 subsequent to the transaction; Steel Heddle Manufacturing Company was acquired in December, 1988.

alscharl.ml

TESTIMONY OF
THE COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS
OF THE
FINANCIAL EXECUTIVES INSTITUTE

February 23, 1989

INTRODUCTION

These observations are presented by the Committee on Investment of Employee Benefit Assets (CIEBA), which is a committee of the Financial Executives Institute (FEI).

The FEI is an association of approximately 13,000 financial executives representing some 7,000 American corporations. CIEBA itself has 40 regular members and approximately 150 advisory members, all of whom are corporate ERISA-governed benefit plan sponsors with collective assets that total more than $450 billion.

The corporations represented in CIEBA cover a broad range of industry groups and asset size. However, it is important to note that CIEBA members - who manage their plan assets on behalf of more than 6,000,000 union and non-union plan participants - speak from the vantage point of those charged with fiduciary responsibilities under ERISA.

These comments are presented to the Committee not to address the specifics of potential legislation, but to provide some background on the investment of pension fund assets and to comment on related issues under investigation by the Committee. Although there are tax policy issues currently being debated that cause us concern, owing to their potential impact on the capital markets, we defer in those discussions, to the extent that they are not related to pension funds, to others with more expertise in tax policy. (The FEI has two such groups, the Committee on Taxation and the Committee on Corporate Finance.)

PENSION FUNDS AND THE U.S. RETIREMENT SYSTEM

We believe that, as currently structured, operated, and regulated, the retirement system in the U.S. has been on balance quite successful in securing retirement income for U.S. workers. It has remained healthy through the best and the worst of times in the financial markets and in the world for fifty years and more, in some cases, and benefits are more secure today than ever before. The aggregate private plan asset to liability ratio stood at 1.38:1 in 1987, and only about 17% of private plans are estimated to have been funded at less than 1:1 in that year.[1]

This mark of success can be attributed to a number of factors: the tax law which allows assets to accumulate without a tax burden; healthy financial markets over the past several years; and prudent asset management and funding strategies on the part of plan fiduciaries, working under the governance of ERISA since 1974. Besides establishing standards for investment practices, ERISA wisely, in our opinion, gives plan sponsors the flexibility to have investment policies that can evolve with the markets, subject to prudent expert tests. As a result, sponsors have been able to enhance fund returns and improve diversification by investing in a broad range of financial instruments and investment opportunities, some of which did not exist in 1974 when ERISA was crafted.

In addition to its achievements in securing benefits, the pension system, including both private and public sector retirement plans, has become the single largest source of institutionalized savings in the U.S. today. Despite a savings rate in the U.S. that compares unfavorably with other industrialized nations, the pension system has continued to be a growing and dependable source of capital for investment in the economy.

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[1] Source: Employee Benefits Research Institute

Few countries in the world place the retirement income burden so heavily on the private sector as does the U.S., and thus far, the results speak eloquently for caution in considering any changes. We urge the Committee to proceed with that thought in mind, and to be alert in addressing broader revenue or tax policy questions to the unintended implications for pension funds, in terms of both benefit security and general economic efficiency. Particular care should be taken to guard against unintended consequences or hardships for defined benefit plans, which are generally held to be most beneficial to participants.

CURRENT SYSTEM OF GOVERNANCE, OVERSIGHT AND REGULATION

Corporate plan sponsors operate within a system of economic checks and balances that goes beyond the essential legal framework. It is created by the economic nature of the pension system itself. Corporate plan sponsors understand that economic prudence, not just legal prudence, on behalf of both the plan participants and the corporate shareholders, requires a careful and continuous assessment of the tradeoffs between the opportunity to reap investment gains and the risk of loss.

In defined benefit plans, the sponsor has a legal obligation to deliver a promised level of benefits to the participants. Those benefits are paid for by a combination of corporate contributions and the earnings on the investment of those contributions. Defined benefit plans comprised approximately 27% of private plans in 1987, but accounted for 66% of trusteed private plan assets and, in 1985 (the most current data available), covered 72% of private plan participants.[2]

The plan participants and the corporate shareholders both benefit from investment policies aimed at maximizing pension fund returns subject to prudent risk-taking. For participants, higher fund earnings increase the security of benefits, and create less reliance on the corporation's ability to make future contributions. For shareholders, higher earnings reduce the amount they will ultimately have to pay to support a given level of benefits, and increase the dollars available to reinvest in the company's growth or to pay dividends. This, in turn, can help American companies in the aggregate be more competitive globally.

Similarly, participants and shareholders alike have a stake in controlling pension investment risk. If the value of contributed assets is decreased by investment losses, the participants will have to depend more heavily on future corporate contributions to secure their benefits. The shareholders will be required to pay more to deliver promised benefits, possibly detracting from the company's competitive position. Ultimately, it is the corporation and thus the shareholder - not the participant - who bears the risk of inadequate returns or investment losses in a going concern's defined benefit plan.

Many companies provide both defined benefit and defined contribution plans; some offer only one or the other. In a typical defined contribution plan, both the plan sponsor and the plan participants contribute specified amounts to the pension fund, and the earnings on those contributions are the only additional funds available for paying benefits. The participant, therefore, again stands to benefit from investment strategies aimed at maximizing return and controlling risk. The shareholder, although he has a less direct stake in a defined contribution plan than in a defined benefit plan, has an interest in prudent asset management because significant losses or relative underperformance would undoubtedly cause problems with employee welfare, morale, and productivity.

Aside from these economic considerations, which provide the strongest incentive for prudent asset management, it has been our experience that the overwhelming majority of pension plan managers live responsibly within the rules of all applicable laws and standards. In addition, through organizations such as CIEBA, most pension fund managers are proactive in their efforts to foster and maintain ethical standards. Since the enactment of ERISA, abuses by corporate sponsors have been rare.

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[2] Source: Employee Benefits Research Institute

ERISA is the major form of legal oversight for private pension funds. ERISA is jointly enforced by the DOL and the IRS, and is explicit in its requirements for prudence in asset management. In Section 404, the prudent man standard has been interpreted and applied as a prudent expert standard, requiring that a fiduciary "shall discharge his duties . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[3] This is a higher standard than other corporate/security laws, which only require that there be no negligence or gross negligence. ERISA also prohibits certain transactions (Section 406); for example, it has very strict and well-defined rules governing the financial transactions of the plan with the corporate plan sponsor. In addition to ERISA, pension funds, like any investor, are subject to various reporting and other requirements of most federal and/or state securities laws.

In addition to the economic and legal incentives for prudence, there are significant checks and balances in place in the current system.

> First, checks by independent institutional fiduciaries are an added assurance that prohibited transactions do not occur. Assets must be held in trust, most commonly by a trustee bank (except for insurance contracts held by insurance companies), and to make an investment or withdraw funds, the plan management must direct the trustee to carry it out. The trustee has a legal obligation to check for prohibited transactions because it is a co-fiduciary. In effect, in order to misuse the plan assets, a plan sponsor would have to have the consent and knowledge of the trustee and the money manager involved.
>
> Second, there is typically a committee of the board within the sponsor corporation charged with oversight of the pension plan management. Such committees exist in approximately 92% of companies affiliated with CIEBA, according to our recent member survey.
>
> Third, private plans are audited by independent public accounting firms, and typically also by internal audit staff.
>
> Finally, the Department of Labor audits a sample of private funds each year. The DOL has also been aggressive in policy-making and in using moral suasion to ensure the proper discharge of fiduciary duties on such issues as proxy voting and directed brokerage.

INVESTMENT OF PLAN ASSETS

ERISA requires that fiduciaries discharge their duties "solely in the interest of the participants and beneficiaries" and "for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan".[4] This requirement means that plan fiduciaries must make investment decisions to provide the best possible assurance that the pension promise will be honored; therefore, the overall fund return should be maximized subject to a prudent level of risk. The appropriate level of risk is determined by a variety of factors, including the plan's projected payout obligations, the extent to which assets already in the fund cover projected liabilities, and the ability of the corporation to make future contributions.

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[3] Employee Retirement Income Security Act of 1974 (ERISA), Section 404(a)(1)(B)

[4] Employee Retirement Income Security Act of 1974 (ERISA), Section 404(a)(1)(A)

In the investment process, the first and most fundamental decision made is the asset allocation decision, or what proportions of the fund should be invested in various asset classes such as stocks, bonds, real estate, etc. The allocation decision is based on analysis of the risk/return characteristics of alternative investments, the correlations among their return patterns, the fund's liquidity needs based on anticipated contributions and payouts, and other factors. The risk of the total portfolio is reduced by diversifying investments among and within asset classes, because judicious diversification serves to partially offset relative under- and overperformance in some assets with that of others. ERISA, in fact, explicitly charges fiduciaries to "diversify . . . the investments of the plan so as to minimize the risk of large losses . . .".[5] Some of the investments included in a well-diversified portfolio could be judged in and of themselves to have a relatively high element of risk, but could prudently be included if the expected returns were commensurate with the risk and if the proportion of such assets were sufficiently small. Designing a portfolio to include such assets can increase the expected return of the total portfolio without proportionally increasing the total portfolio risk.

After the asset allocation decision is made (or revised), the funds are committed (or shifted), either by means of "in-house" investing or through independent investment managers. It should be emphasized that the asset allocation does not typically change significantly over the short term, and plan sponsors, governed by the long term nature of pension payout obligations, generally invest with a long term view. Although liability profiles differ among corporations, sponsors are generally less concerned with short term movements in valuations of asset classes than with longer term expected returns of the entire diversified portfolio.

Recently, attention has been brought to bear on increased short term asset turnover among "active" investment managers (i.e., those who attempt to exceed the return level of the overall market), some of whom manage pension fund dollars and, it has been postulated, trade more frequently because of pressure for short term performance from plan sponsors. It is our belief that most sponsors generally evaluate the performance of their investment managers on a three- to five-year time horizon or longer, which suggests that longer term evaluations are the more general rule. If trading volume among these managers has in fact increased, there are also other factors and recent trends in pension management that would balance out such an increase across the total fund. First, pension funds have substantially expanded their investments with "index" or "passive" investment managers, i.e., those who attempt to replicate the returns of the overall market. Trading activity in these accounts is of substantially lower volume than in active accounts. Second, pension funds have increased their investments in the private markets, such as real estate investments, venture capital, etc. Such investments are long term in nature and normally are not traded actively nor through the public markets at all.

It should also be noted that many of our members do not subscribe to the view that active trading per se is necessarily undesirable for the markets. Active trading contributes to overall market efficiency and investment liquidity, which adds to the attractiveness of an investment for most investors.

CORPORATE GOVERNANCE ISSUES (PROXY VOTING)

Although pension funds purchase equity securities for investment rather than control purposes, we are ipso facto owners of corporations as well. With ownership comes the responsibility to exercise ownership rights, including the voting of proxies. In accordance with ERISA, these voting decisions, like investment decisions, must be made solely for the purpose of furthering the interests of plan beneficiaries. In a change of corporate control situation, this requires approaching the decision with no bias toward either the existing management or the prospective acquirer, and maintaining continual study and analysis of the actions of all parties to assess where the greatest value lies.

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[5] Employee Retirement Income Security Act of 1974 (ERISA), Section 404(a)(1)(C)

As required by the recent DOL opinion letter regarding proxy decisions, such decisions are made either solely by the sponsor, or solely by the investment manager who is managing the investment. If the sponsor does not reserve the right to make the voting decisions, it cannot interfere with the decisions of the investment manager, who will have been charged to vote according to the best interests of the plan beneficiaries.

PENSION FUND INVESTMENT IN LEVERAGED BUYOUTS (LBOs)

The 1980s have been a time of heightened corporate restructuring activity of many kinds, including divestitures, asset sales, mergers, acquisitions, and LBOs. Much of this activity, we believe, can be attributed to changes in the optimal mix of corporate assets and business ventures demanded by a rapidly-changing and increasingly globalized business and economic environment, as well as to an unwinding of some of the conglomeratization activity seen in the 1970s.

At the same time, we have seen a significant expansion in the aggregate level of corporate debt - a phenomenon that we believe should only be evaluated after a thorough examination of a wide range of factors, including the relative indebtedness and competitive position of U.S. firms vis-a-vis their foreign counterparts. While the complete picture of what has driven this second trend has not yet become clear, it is certainly true that any kind of restructuring activity can be financed with a large proportion of debt, and indeed there are significant tax incentives attached to doing so. Other corporate actions, such as stock repurchases and borrowing for capital expenditures, can also heavily weight a capital structure in favor of debt and increase financial risk.

Accordingly, it is our belief that it is important for the Congress to analyze LBO activity in its broader economic context, not as the sole driver of these more fundamental trends. Even though an LBO is largely financed with debt, and so most likely makes a greater than proportional contribution to the aggregate level of corporate debt, we feel that an attempt to address these broader trends by targeting LBO activity would be ineffective and might possibly have unintended consequences for other sectors of the markets.

According to our recent CIEBA member survey, approximately 1% of our assets are invested in LBO equity and/or debt, and about 30% of our members commit funds to these investments. Investments are made either through limited partnerships or, for a few very large funds, by means of direct investments in individual companies. Partnerships are managed by a "general partner," who typically invests only a relatively small proportion of the total capital, but shares more than proportionally in the profits from the investments. General partners also charge fees for managing the fund. Partnerships offer the protection of added diversification, since the funds own or invest in more than one company (typically a dozen or less); the "limited partners" (pension funds and others) are thereby largely shielded against a failure in any one company.

Sponsor fiduciaries who do invest in LBOs do so because they provide a high level of expected return and they enhance the return of the overall fund. Among CIEBA members, mature partnership investment returns typically have ranged between 25% and 60%, with no investment losses to date. (Mature investments are the relevant measure; LBOs typically are structured with a four- or five-year time horizon with only minimal returns, or none at all, expected in the early years.) Returns on direct investments are in general higher, largely because of the absence of a general partner: there are no partnership management fees, and profits are not shared with a general partner. Since these investments are in individual companies, they do not provide the protection of diversification that partnerships do, and they therefore require more extensive analysis that would generally only be feasible for large, reasonably well-staffed plan sponsors.

While the returns associated with LBO investments are typically very high, they do carry higher levels of risk than most other forms of pension investments. Risk, however, cannot be isolated as the sole criterion for evaluating an investment. The investment must first be evaluated individually, balancing the risks against the expected returns, and then as a component of a larger portfolio of assets. Individually, the level of risk present in any investment is directly related to its expected returns: assets in demand in the marketplace, by pension funds as well as other investors, are in demand only while their expected returns exceed or are commensurate with their perceived riskiness. In a portfolio, each asset's effect on the risk/return profile of the entire portfolio is the relevant measure for tests of prudence, not just the riskiness of each individual asset. As outlined earlier, including a relatively small proportion of high risk/return investments in a portfolio can enhance the overall return of the portfolio without proportionally increasing the overall level of risk.

Pension fund investments in publicly traded high-yield bonds must be examined in a similar way. High-yield bonds are less than investment grade debt (generally, below a BBB rating), with relatively high risk and expected returns. While they are used to finance some LBOs, they also provide access to the debt markets for emerging credits, or companies which are not yet healthy or large enough to merit an investment grade rating, and for companies whose debt ratings have been downgraded.

As noted, we found in our survey of CIEBA members and advisory members that about 1.0% of our pension fund assets are invested in LBOs, including both direct investments and limited partnership investments. LBO investments and publicly traded high-yield bonds together constitute only about 2.3% of our assets. With such a small proportion of assets involved, even failure of all such investments would not jeopardize the security of the pension promise. In fact, as noted earlier, the overall financial status of private funds is quite healthy, even as such investments have become more commonplace.

In order to further reduce the potential risks to the assets invested, we are also diligent in our analysis of LBO investments, as we are for all investments, recognizing that risk is a key element in these transactions. For partnership investments, we examine the history and experience of fund managers, in terms of experience, background, record of price discipline, whether or not they invest in hostile takeovers, and other factors. For direct investments, we perform extensive financial analyses based on worst-case and recession scenarios. After investing, we exercise due diligence in monitoring, as again we do for all fund investments.

Even though the aggregate proportion of our funds invested in LBOs is quite small, and our perspective is that of the investor, not of the economist, we do not make investments that we believe may be detrimental to the economy over the long term, because we would be doing a disservice to our fiduciary responsibilities by damaging our future investment opportunities. While we would not assert that all LBOs and high-yield debt financing decisions are strategically sound, we believe that a conclusion that all such activity is inherently harmful to the economy would be equally inaccurate.

We do not propose to enter the debate about the economic implications of LBOs as a proponent or as a critic. There is, in fact, no consensus of opinion within CIEBA on either side; neither does there appear to be a consensus among government officials, in academia, or in many other sectors. The potential negatives have been amply covered in the press and in other Congressional testimony, and these views are shared by some of our members. They raise questions about the fate of these companies should the economy slide into a recession, the implications for employment and divestiture of assets, the negative effect on the value of the company's already outstanding debt securities, and the potential incentive for divergence of funds to debt service from investments in such activities as research and development.

CIEBA members who have a more favorable view of LBOs point out that LBOs can have many positive economic effects and can serve worthwhile economic purposes. Some (35% of LBOs in 1988) are undertaken simply because of a desire to sell on the part of the current owners, such as in corporate divestitures and sales of family-owned or otherwise closely held businesses.[6] Most result in extremely high returns to the existing shareowners, including pension funds. With regard to the longer term implications for productivity and employment, these members feel that a capitalistic economy in the aggregate becomes more efficient in transfer of control situations, because employees and assets will tend to be reallocated toward their "highest and best use," even if short term dislocations occur. In the aggregate, the national unemployment figures will not support the supposition that most dislocated employees remain out of work.

There is also debate about whether or not the Treasury suffers a net revenue loss in an LBO. Some commentators have postulated that the Treasury in fact reaps a net benefit from an LBO: while interest deductibility reduces revenue from corporate income tax, the loss may be more than offset by tax revenues from sometimes more than 100% capital gains by taxable shareowners, from tax on interest earned by taxable debtholders, and from tax on fees earned by agents. Few LBOs, incidentally, are disproportionately large in dollar value; in 1988, fully 94% were under $1 billion in transaction size, with 88% under $500 million.[7]

The notion that does come through clearly, in our opinion, is that this issue is extremely complex and requires much deeper analysis than has been possible to date, and more time for the underlying economic forces to surface. We urge extreme caution in crafting a legislative solution at this time. Overall, we feel that the market itself is the best regulatory mechanism for excesses, if they exist, and that it has, in fact, already begun to adjust. A legislative correction, besides being extremely difficult to design at this relatively early stage, carries with it the added risk of creating distortions in the markets and hampering their ability to self-adjust, especially if new laws should result in differential treatment among market participants. As the market forces evolve, close monitoring and study may reveal that legislation is in order, but until then, we feel that the risks outweigh the possible benefits.

For pension funds in particular, we would be seriously concerned about any prohibition or limitation on pension fund investment in LBOs or other investment options for several reasons.

> First, there are more than enough economic and legal safeguards in place to assure that benefits are not being jeopardized, and the current participation level for the investments currently receiving attention is far too low to cause concern for benefit security. We believe that ERISA is quite clear in its charges to fiduciaries, and that the flexibility it permits in allowing investment policies to evolve with the markets is an integral part of that mission.
>
> Second, if the independent policy decision is made to curb LBO activity in general, then we do not believe that that goal could or should be accomplished by amending ERISA, which would affect private pension fund participation. As long as investment returns remain attractive, any void left by the absence of private pension dollars would quickly be filled by other providers of capital not subject to government restrictions, such as foreign investors. We again believe that the market is best equipped to place a check on excesses, if they exist; when opportunities for advantageous realignment of assets abate, the pace of restructuring activity seen in the 1980s, of which LBOs are only a part, will undoubtedly slacken unaided.
>
> Third, from a larger perspective, we believe that restrictions on corporate restructuring should be carefully

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[6] Source: Venture Economics, Inc., Wellesley Hills, MA

[7] Source: Venture Economics, Inc., Wellesley Hills, MA

examined for their unintended implications for the viability of the capital formation process. Eliminating financial buyers such as pension funds or buyout partnerships would limit many companies' options for sources of capital to other corporations or non-U.S. investors, and could possibly work to the detriment of corporations in their asset redistribution activities.

Finally, as we pointed out at the beginning of this testimony, we would urge caution in tampering with a retirement system that works, and that has withstood far more severe tests than this for many years. We are confident that it will survive this one.

DECEMBER 23, 1988

SUBJECT:

ROBERT J LEONARD, CHIEF COUNSEL
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, D. C. 20515

RE: TAX POLICY WITH REGARD TO MERGERS, ACQUISITIONS, LBO'S ETC.

IT HAS ALWASYS STRUCK ME AS VERY UNFAIR TO STOCKHOLDERS TO HAVE CORPORATE DIVIDENDS TAXED AT THE CORPORATE LEVEL AND THE INDIVIDUAL LEVEL. UNTIL RECENTLY, REVENUE CONSIDERATIONS SEEMED TO MAKE IT IMPOSSIBLE TO CHANGE TAX TREATMENT IN THIS AREA.

HOWEVER, THE RASH OF MERGERS, ACQUISITIONS, AND ESPECIALLY LBO'S INDICATES THAT MANY COMPANIES AND INDIVIDUALS HAVE FOUND A WAY TO REDUCE THIS BURDEN IN MANY CASES. BY CONVERTING EQUITY TO DEBT, NON-DEDUCTIBLE DIVIDENDS ARE CONVERTED TO DEDUCTIBLE INTEREST.UNFORTUNATELY, THIS CREATES A NUMBER OF OTHER PROBLEMS.

INSOFAR AS IS POSSIBLE, I BELIEVE WE SHOULD MOVE TOWARD A TAX POLICY THAT ALLOWS CORPORATIONS TO DEDUCT DIVIDEND PAYMENTS AS WELL AS INTEREST. PERHAPS WE COULD PHASE THIS IN AT 10% TO 15% PER YEAR UNTIL DIVIDENDS ARE FULLY DEDUCTIBLE TO CORPORATIONS.

SINCERELY,

James K. Dudeck

JAMES R. DUDECK
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JACKSONVILLE, FL 32216

STATEMENT OF THE EDISON ELECTRIC INSTITUTE

The Edison Electric Institute (EEI) is the association of investor-owned electric companies. Its members serve 97 percent of all customers served by the investor-owned segment of the industry. EEI members generate approximately 77 percent of all electricity in the country and provide electric service to 73 percent of the nation's ultimate electricity customers. We appreciate the opportunity to submit this statement with respect to this Committee's hearings concerning the tax aspects of mergers and acquisitions.

Numerous proposals, mainly in the area of corporate taxation, have been suggested as a means of remedying the perceived abuses of mergers and acquisitions, leveraged buy-outs (LBOs), and the concerns about high levels of corporate debt. While others have commented on broad economic concerns, with one exception, our comments will be restricted to the impacts on our customers and investors. The one broad comment we would make is that as a guiding principle, generally, we believe that capital markets should be given the maximum opportunity to operate, and legislative restrictions should be applied only where there is wide agreement that there are significant abuses which must be remedied.

M&A Activity in the Electric Utility Industry

The incidence of mergers and acquisitions in the electric utility industry has been at a low level historically, and this trend does not appear to be changing significantly. Moreover, those mergers and acquisitions which do occur are typically motivated by the objective of reducing the cost of producing electricity through achieving cost-reducing operating efficiencies. Unlike most of the highly-publicized LBOs and mergers, such transactions are always the subject of intense scrutiny by multiple electric utility regulatory bodies. In fact, recent merger and acquisition proposals have drawn increasingly larger numbers of intervenors into the proceedings, thereby intensifying regulatory scrutiny. Moreover, unlike some highly-leveraged acquisitions, recently completed M&A activity in the electric utility industry generally has been accomplished by exchange of stock, rather than issuing debt as in some of the much-publicized LBOs.

Unintended Consequences Should Be Avoided

In exploring the issues that are the subject of the hearings, the increasingly significant role of the electric utility industry in our nation's economy should be considered, since any action to curb LBOs may have inadvertent effects. Use of electricity as a percentage of U.S. energy requirements has grown from 32.2 percent in 1980 to slightly over 37 percent in 1987. Since 1973 when energy became a critical national issue, electricity use in the U.S. has increased over 40 percent while total energy use has increased only 2 percent.

Moreover, there is an increasing concern about the adequacy and reliability of electricity supply in the mid-1990s and beyond. In order to provide the adequate and reliable electricity, our industry is heavily dependent on stable and efficient capital markets. We invest billions of dollars annually in generation, transmission and distribution plant and equipment, making our industry the most capital-intensive industry in the U.S. In fact, we invest about $2.89 in land, buildings and equipment for every dollar of operating revenue. By comparison, the average manufacturing firm invests only $0.77 for every dollar of sales. In 1987, the construction program of investor-owned electric utilities totalled $27 billion.

Tax legislative proposals which impact interest and dividends could significantly increase the cost of electricity and could lead to additional difficulties in providing an adequate and reliable supply of electricity. Thus, these proposals could well adversely impact businesses that are not involved in what some would term abusive mergers, acquisitions and LBOs, and we, therefore, strongly encourage the Committee to carefully consider and analyze any possible legislation for unintended harmful impacts on our consumers and investors.

The Wide Sweep of Proposals Suggest the Need for Particular Caution

EEI is particularly concerned with many of the possible tax changes which have been suggested by various parties in response to the high visibility of certain leveraged buy-outs. These changes include, but are not limited to, suggestions for reducing or completely eliminating the deductibility of business interest. In particular, EEI is concerned with the thought set forth by some that interest payments are an alternative form of distributing operating income. Interest payments represent an expense of doing business comparable to any other business expense and, under long-standing tax law, are appropriately deductible in computing taxable income. In order to meet the obligation to serve contained in franchises, electric utilities must borrow money to build plants. Electric utilities account for about 20 percent of investment grade fixed-income securities outstanding, the largest sector in a Salomon Brothers' survey of outstanding debt securities.

Our regulators, too, treat interest expense as an expense of doing business. Essentially, our capital structure is regulated and virtually all regulatory bodies closely review the capital structure of their jurisdictional utilities. This is done to insure that the leverage is appropriate and there is a balance between the cost of capital reflected in the cost of electricity and the financial safety needed to provide an adequate and reliable supply of electricity.

The Need for Tax Law Stability Is Compelling

In analyzing the need for legislative action in this area, we also urge the Committee to consider the vast and sweeping changes which have been made in our tax laws during the 1980s, particularly in the area of corporate taxation, e.g., the over $100 billion increase in corporate taxes enacted as part of the Tax Reform Act of 1986. This decade has witnessed a major tax bill -- either being considered, enacted, or both -- every year. These changes place a significant burden on business. One need look only at the large number of depreciation systems which must be tracked. More importantly, businesses find it extremely difficult to engage in any long-range planning when faced with these frequent tax law changes or even discussions about changes. As an example, the Tax Reform Act of 1986 significantly reduced the cash flow of electric utilities. Thus, we believe that a moratorium on tax legislative changes should be observed in the absence of a compelling reason to proceed with legislation which would make fundamental changes to the tax code.

SUMMARY

Notwithstanding these concerns, EEI is prepared to work with the Committee to assist in studying the need for review of any legislative proposals in response to the leveraged buy-outs and the increase in corporate debt if it is believed that legislation is necessary. However, any such legislation should be carefully studied to determine the need for legislation and all possible effects before any action is taken. We urge the Committee to assess carefully the impact which such proposals could have on our approximately 80 million customers and 5 to 10 million investors. We appreciate the opportunity to present our views to the Committee on these important matters.

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Congress of the United States
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Washington, DC 20515

JUDICIARY COMMITTEE
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SUBCOMMITTEE ON IMMIGRATION
REFUGEES AND INTERNATIONAL LAW
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CRIMINAL JUSTICE
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ENVIRONMENTAL AND
ENERGY STUDY CONFERENCE
CONGRESSIONAL ARTS
CAUCUS
STEERING COMMITTEE
NORTHEAST-MIDWEST
CONGRESSIONAL COALITION
VICE CHAIRMAN
BOARD OF VISITORS
U.S. MILITARY ACADEMY

December 14, 1988

Mr. Peter Singleton
Minority Staff Director
House Ways & Means Committee
1106 Longworth HOB
Washington, D.C. 20515

Dear Mr. Singleton:

Enclosed please find a letter from one of my constituents, Helmy El-Sherif. Mr. Sherif has several interesting suggestions regarding legislation to decrease the tax incentives for corporate takeovers, which you might be interested in.

Thank you very much for your attention to this matter. All best wishes are with you for a happy holiday season.

Sincerely,

Hamilton Fish Jr.

Hamilton Fish, Jr.
Member of Congress

HF:djr

HELMY H. EL-SHERIF
6 Sachs Court, Hopewell Junction NY 12533

November 27, 1988

DEC 5 1988

The Honorable Hamilton Fish Jr.
House of Representatives
Washington, D.C. 20515

Sir:

As you explore ways to reduce the Federal deficit, I would like to present you with a **PAINLESS REVENUE OPTION** which would not only enable you to raise substantial revenues but will also enable you to enhance the US competitive posture on the World Markets, save American jobs, as well as ensure that the American Taxpayers are not robbed by the sharp pencils of Wall Street at the expense of jobs on Main Street. **Sir, I recommend that you propose legislation which would:**

1- Abolish the tax deductibility of interest expense on monies borrowed for Corporate takeovers, and,

2- Treat any payments in excess of book assets value of the acquired business as a good will value, hence not tax deductible item by the new owners, management or others.

The attached information summarizes the impact of a recent proposed acquisition of Prime Computer Company by MAI Basic Four Incorporated. The Analysis, clearly shows how the acquiring concern, will have a positive substantial cash flow, while at the same time **avoiding for ever paying any taxes** and getting the taxpayers to help them finance the acquisition, by sheltering income from other concerns they are active in. The purchase of Prime Computer, valued at about $1 Billion, will rob the treasury of $2 Billion during the coming twenty years. The purchase of RJR valued at about twenty five times as much could easily rob the Country an amount which could be as high as $50 Billion in the same time period. Not only do the new owners deprive the Treasury of badly needed funds, but they also start trimming expenses including research and development, and eliminating jobs; in essence they reduce the number of tax payers. As they do that, they compromise the long term gains to the Country for the sake of their personal short term gains. If the acquisition is a good investment for the stakeholders, it would be carried out regardless of the tax implications.

Sir, I urge you to propose legislation which would eliminate the tax incentives to Corporate raiders. I would be delighted to discuss the matter further with your financial advisors.

Sincerely,

Helmy H El-Sherif

PRIME COMPUTER FINANCIALS BEFORE AND AFTER ACQUISITION BY AMI

FINANCIAL SUMMARY BEFORE ACQUISITION

	1987
Income Before Tax($M.)	86
Taxes ($M.)	22
Income After Tax ($M.)	65
Net Assets ($M.)	256
Company Value:	
Shares	61,189,000
Price per Share ($)	16
($M.)	979

Aquisition BY MAI BASIC 4

Shares	61,189,000
Price per Share ($)	20
($M.)	1,224

Tax Treatment

Pre-Acquisition Net Asset Value($M.)	256
Post Acquisition Asset Value($M.)	1,224
Extra Depreciation Caused By Write Up Of Assets Assuming 15 Year Life ($M.)	65
Leverage Financing (90% of Value)	1,101
Annual Interest of Purchase Debt (10%)	110

Post Acquisition Financial Summary

Income Bevore Tax ($M.), Old Company	86
Annual Interest of Purchase Debt (10%)	110
Earnings before Interest and Tax ($M.)	(24)
Extra Depreciation Caused By Write Up Of Assets Assuming 15 Year Life ($M.)	65
Taxable Income ($M.)	(89)
Tax Credit, 26% ($M.)	(23)
After Tax Income ($M.)	(66)

Cash Flow:

Income After Tax ($M.)	(66)
Old Company Depreciation ($M.)	81
Extra Annual Depreciation ($M.)	65
	80

PRIME COMPUTER COMPANY

IMPACT OF ACQUISITION BY MAI

INCOME AND EXPENSE STATEMENT		
	PRE-ACQUISITION	POST ACQUISITION
INCOME BEFORE TAX	$ 86 M.	$ 86 M.
- COST OF PURCHASE DEBT (10%)	0	110
	86	(24)
- EXCESS DEPRECIATION DUE TO WRITE-UP OF ASSETS	0	65
TAXABLE INCOME	86	(89)
- INCOME TAXES (26%)	22	(23)
NET INCOME, OR (LOSS) LOSS USED TO OFFSET OTHER NET POSITIVE INCOME.	$ 65 M.	$ (66) M.

IMPACT ON CASH FLOW		
NET INCOME FROM OPERATIONS	$ 65 M.	$ (66) M.
+ ANNUAL DEPRECIATION	81	81
	146	15
+ EXCESS ANNUAL DEPRECIATION DUE TO WRITE-UP OF ASSETS	0	65
	$ 146 M.	$ 80 M.

RESULTS: ' UNCLE SAM' LOSES;		
TAXES	$ 0 M.	$ 440 M./20YRS.
TAX OFFSETS FROM OTHER PROFITS	0	1,078
	$ 0 M.	$1,518 M./20YRS.
' MAI'GAINS ;	$ 0 M.	$1,963 M./20YRS.

Sources: Company Annual Reports, Wall Street Journal

STATEMENT OF
BRIAN F. WRUBLE
CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER
EQUITABLE CAPITAL MANAGEMENT CORPORATION
SUBMITTED TO THE HOUSE WAYS AND MEANS COMMITTEE
MARCH 15, 1989

My name is Brian F. Wruble. I am Chairman, President and Chief Executive Officer of Equitable Capital Management Corporation, based in New York City. Equitable Capital is a subsidiary of The Equitable Life Assurance Society of the U.S., a mutual insurance company and the third largest life insurer in the United States. I also serve as an executive vice president of The Equitable and a member of its Investment Policy Committee.

Equitable Capital is an investment management firm, with approximately $33 billion in assets under management. These span a number of asset classes, including common stocks, publicly traded bonds, corporate loans in the form of privately placed bonds, government and agency securities, futures and options, and venture capital. About two-thirds of the assets we manage belong to our parent company or its affiliates. The remainder is managed for "third party" clients, including corporate, state and municipal pension plans, other financial intermediaries and international clients in Europe and the Far East.

On behalf of both our parent and a number of outside clients, we manage a large portfolio of publicly traded high yield bonds, many of which are associated with corporate restructures of one kind or another. In addition, we are one of the largest private investors in leveraged buyouts. For approximately 100 leveraged buyout transactions, we have been heavily involved in the restructuring itself, providing most or all of the subordinated debt. Our first such investment was completed about 15 years ago, but most of our activity in this area has taken place since 1983. In many of these companies, we also acquired substantial common stock or warrants to buy common stock. It is these 100 investments, where we have had a real chance to observe how the newly restructured companies operate, that have really given us insight into the leveraged buyout process.

We recognize there are some flaws in the LBO process, but on-balance, remain convinced that it is extremely beneficial for the U.S. economy. We believe that utilizing tax policy as a way of curbing abuses is far too blunt an instrument.

At Equitable Capital, we do not finance hostile acquisitions — not because we think they are immoral, but because the risks involved are greater than we feel comfortable with. Generally, we do not invest in companies where large parts of the company will be broken off and sold to others. Again, this is not because we think these are evil, but because they involve a type of "warehousing" risk that we don't normally wish to bear. We are not, for example, a part of the RJR-Nabisco transaction.

The names of most of the companies whose leveraged buyouts we have financed are not familiar to most people. The companies in our portfolio tend to be smaller businesses. They are often companies sold by conglomerates to their managers or retired founders passing an orderly transfer of control to the next generation of managers. Some are smaller public companies being taken private to escape the short-term focus on reported earnings and the costly reporting requirements of public ownership. ***This kind of LBO, the small, private, non-hostile, non-"bust-up" deal is the mainstream of the business.***

According to one study, nearly 90% of last year's leveraged buyouts involved purchases of companies for less than $500 million. About 35% were smaller than $50 million.[1] The "mega-deals" get all the press attention, but the real All American deal involves the essence of the American Dream. It involves managers buying the business they have been running their entire career from a large and bureaucratic corporate owner; from an individual owner/manager who is retiring; or from anonymous and uninvolved public shareholders.

From what I hear and read, there are several issues surrounding the leveraged buyout phenomenon that are troubling to some members of Congress. These issues seem to be:

- Do leveraged buyouts cause unemployment?
- Do leveraged buyouts reduce competition?
- Is American business becoming overburdened by debt, perhaps making our economy more fragile, more vulnerable to recession?
- Is debt making our companies less willing or able to spend on research and development (R&D) or capital expansion, and reducing their long-term ability to compete globally?
- Is the use of debt being unfairly "subsidized" by the U.S. taxpayer, thereby exacerbating the budget deficit?
- Do LBOs result in an unfair transfer of wealth from existing bondholders to new stockholders?

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[1] "Middle-Market Deals Dominated Activity in Buyouts in 1988", *Buyouts* (January 11, 1989); p.2

Before I briefly address our view on each of these, let me say the following:

> Equitable Life seeks to be a good corporate citizen. As a mutual life insurance company, we are operated on behalf of millions of life insurance policyholders. We must comply with strict standards of fiduciary responsibility. We constantly ask ourselves whether our investments are socially desirable and productive. We believe that the restructuring activity taking place in America is an urgently needed process of renewal, of "regreening", of "re-entrepreneuring" the economy. We believe that leveraged buyouts are, as an investment class, a good thing. Like all investments, including stocks and bonds, some will be mistakes. That is the nature of investment risk. But we believe LBOs are helping to put back into American industry a competitive edge that has been lost.

THE EMPLOYMENT ISSUE

I remember, in the 1950s, when the word "automation" was causing considerable economic debate. Both government and labor expressed the concern that machines would replace men and women, that the new computers would throw millions of workers out of their jobs. A shortsighted analysis can easily lead to that conclusion. If a machine is purchased by an auto manufacturer to do a job that a man had done previously, and if that man is then laid off, have we not increased unemployment? Yes, but only over the short run and only at a specific plant. In the long run, that company was able to remain more competitive than it would otherwise have been, retaining more jobs, and even increasing employment. At the same time, the makers of computers and other automated machinery were able to grow rapidly, themselves becoming major providers of jobs and the core of an industry where America has held the international lead for many years.

Today we face a similar situation. Leveraged buyouts promote efficiency by cutting unnecessary expenditures, and, of course, some of those costs may be employment costs. However, it is the long-term effects that must be examined. The critical question is whether companies that go through the leveraged buyout process become more efficient and more competitive. If the answer is "yes", then any long term, dynamic analysis will show that leveraged buyouts help to increase employment by improving the ability to compete internationally. How would a visitor from another planet observe things? He would have a hard time understanding this concern about unemployment. He would see a decade in which leveraged buyout transactions grew into an annual business activity, totalling $100 billion. At the same time, he would see a decade of rapid increases in employment, with the percentage of the population employed at an all time high and the unemployment rate at a ten year low.

On a more anecdotal level, let me tell you the stories of two companies in our portfolio of investments.

During the late 1970s, The Equitable held a $100 million loan to a large"A"-rated corporation, a manufacturer of electric generating machinery equipment and farm equipment. The trends we foresaw in those sectors were troubling to us, so we called management in and said to them: "The world is changing; your industry is changing; but you're not changing. You can't continue to run your business as you have been over the last twenty years. What are you going to do about it?" The managers were insulted. They were outraged at the criticism and rejected the idea that there was anything wrong with the business. Today that company is in bankruptcy. Many jobs were lost. A leveraged buyout could have saved it. Going through an LBO creates an artificial crisis, a sense of urgency, a fierce desire to examine every detail of the corporate strategy to assure that the company can grow and survive. The company in our example lacked that sense of crisis. By the time they saw the iceberg, it was too late to avoid the collision.

My other example is a lot less grim. In 1983, The Equitable was involved in the leveraged buyout of a textile manufacturer. The managers who bought the company had tremendous pressure on them to make it perform. They faced two possibilities. With success, they could become masters of their own destiny and quite wealthy. With failure, they would lose all of their considerable personal investment as well as their careers. They responded as pure economic animals. They streamlined their product line, sacrificed their executive "perks" (which they had come to think of as waste), and demanded excellence from their employees, a number of whom were also new stockholders. Like any company that has experienced an LBO, this manufacturer used the discipline of its new debt burden to batten down the hatches and get the company moving in the right direction.

It was lucky that they did. About six months after they went private, a severe downturn hit the textile industry, the result of a strengthening dollar and vicious import competition. The company survived the recession and in much better shape than their competitors. Today their business is functioning stronger than before. The lesson to be learned is this: Companies which undergo a leveraged buyout tend to perform well during recessions because they're already running a tight ship. There is no question that, today, employment at the textile company is much greater than it would have been without a restructuring.

LEVERAGED BUYOUTS AND THE SPIRIT OF COMPETITION

Although RJR-Nabisco may raise questions about concentrations of economic power, the mainstream of the leveraged buyout business is the management purchase of businesses formerly owned by larger companies, typically conglomerates. Making new, smaller companies out of larger, more financially powerful ones has an encouraging effect: These "scrappy" new companies become fierce competitors. They fight hard for market share, and ultimately, it is the consumer who benefits. Again, what would a visitor from another planet find? He would see a period of dramatic disinflation occurring at the same time that leveraged buyout activity exploded. LBO success has obviously not been driven by the kind of price increases that one associates with reduced competition.

ADDRESSING THE CONCERNS ABOUT DEBT

Is American Industry becoming dangerously burdened by debt? We don't believe so. Obviously, adding debt to any company's balance sheet increases the financial risk of the company. The firm becomes less able to withstand a downturn in its cashflow. However, the ***total*** risk in any company is a combination of its financial risk, (i.e. the debt leverage), and its business risk. If we can make the company more focused, more efficient, and more competitive, then we reduce its business risk considerably. A study recently cited by *Fortune*[2] stated that "operating profit margins of LBO companies were 40% higher than their industries' medians two years after a buyout."

To achieve this improvement in business strength, ownership is placed in the hands of management by lending them most of the purchase price of the company. That temporarily increases financial risk, at least until the debt is paid down to more normal levels. There is a trade-off of reduced business risk for temporarily increased financial risk.

The amount of leverage added to a company that experiences an LBO is, in most cases, not as extreme as some seem to think. Typically, leveraged buyouts have about 10% of their total assets supported by equity. The average industrial company in the Value Line Composite Index has only about 40% of its assets supported by equity. It should be noted that if a company does "fail", rarely will it actually cease to exist; rather, creditors would take over to control operations.

In order for a leveraged buyout to take place, a number of different parties to the transaction must have independently examined the proposed investment. They must conclude that future cashflows are: (1) able to be accurately forecast despite the possibility of recession; and (2) likely to be strong enough to meet contractual debt payments. Senior lenders, normally banks, must do this analysis and satisfy themselves. Subordinated lenders, like Equitable Capital, must independently reach the same conclusion. Equity investors, including the managers who are buying the company and risking their own money, must do the same. Each of these groups stands to lose part or all of its investment if they are wrong. Each investor carries out its analysis with great diligence. Each team has veto power on the entire transaction since all elements of the financing must be assembled if the deal is to take place.

The result of all this scrutiny is that LBOs tend to take place in those industries for which cash flow is most stable, even when recessions occur. A recent study by Morgan Stanley bears out what we have observed in our own investing activity. To wit, there has been "... a concentration of leveraged buyouts in the industries that are best equipped to support them."[3] These industries exhibit low cash flow volatility and a high level of coverage of their fixed charges on a historical basis. Our own portfolio, for example, shows a concentration in broadcasting companies, newspapers, grocery chains and retailers, as well as specialty manufacturers who make products to serve the needs of stable end-markets. As a matter of investment policy, we do not invest in companies for which commodity price movements are critical, those which involve style or fashion, or where technology or the success of R&D is critical. The cash flow of these are all very difficult to forecast, therefore we do not believe they are appropriate candidates for a leveraged buyout.

IMPACTING RESEARCH AND DEVELOPMENT

We frequently hear the concern that R&D spending will suffer because of leveraged buyout activity. To us, this is not a realistic risk, since those companies for which R&D success is critical make very poor LBO candidates, and investors tend to avoid them. A number of the companies that have been "liberated" from ownership by conglomerates through the leveraged buyout find that they have more cash available to fund needed R&D and capital spending than when their former parent company was milking the excess cash out of them. Wilson Sporting Goods is an excellent example. Having lost much of its market share to competitors — both foreign and domestic — the newly independent and management-owned Wilson has been able to regain share by making investments in product enhancement that were impossible when it was owned by a much larger company.

OFFSETTING DEBT LEVELS WITH IMPROVED QUALITY OF BORROWERS

Finally, is there "too much" debt? Only the future will tell us for sure. However, a recent study by Goldman Sachs, which we agree with, concluded that "... fears that corporate debt increases pose a major systemic threat to the sound functioning of the economy and financial markets and will deepen the next recession seem overblown."[4] The study makes the point that the surge in debt during the current expansion followed a ten-year period of well below average use of debt by non-financial corporations. The current level of corporate debt today, relative to total corporate income, is not significantly different from its level in 1970. Moreover, as we might expect, much of the overall increase in debt is specifically related to leveraged buyout and other restructuring activity. As I have already stated, companies selected for the leveraged buyout are almost always those with the least volatile businesses. Therefore, ***the quality of the borrowers of much of this new debt is much higher than average.*** Their businesses are fundamentally more stable, making them better able to withstand recession.

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[2] J.P. Newport, Jr., "LBOs: Greed, Good Business — Or Both?", *Fortune* (January 2, 1989); pp. 66-68 "

[3] Stephen R. Waite and Martin S. Fridson, "The Credit Quality of Leveraged Buyouts," Morgan Stanley: pp. 9-15

Let me make one more point here. One obvious result of the leveraged buyout activity in recent years is a much higher level of the stock market than otherwise would have been the case. Those who decry the so-called "de-equitization" of the economy miss the point that companies who choose to issue new equity today can do so at much higher prices than would otherwise have been possible. Moreover, the higher stock market has raised the value of corporate and public pension plans. This lowers the cost of funding future retirement, thereby increasing corporate profits and reducing the budget outlays of states and municipalities. The strong equity market has increased the wealth of millions of American stockholders, enabling them to continue to support the longest economic expansion in peacetime history.

Going beyond this, the ease with which entire companies can be bought has a very beneficial effect on the stock market. It serves to dampen volatility, and therefore reduces the volatility of the entire economy. I remember sitting with a colleague around the time of the stock market's bottom in 1974. That was a brutal and protracted bear market. I asked him how it was possible that companies like General Motors could be selling for about four times earnings. His answer was this:

> "Stocks are only pieces of paper. They are only worth what someone else will pay you for them."

Today, the leveraged buyout investor, operating on the most rigorous of analyses, will buy an entire company if the price gets too low. Stocks no longer can become "just pieces of paper", detached from their investor value. Conversely, the LBO investor will not buy if the price gets too high, because the banks and insurance companies will not lend him the money. This provides a new stability to the stock market and to our economy. We saw the importance of this factor on October 19, 1987. Many observers will tell you that it was the threat to the tax deductibility of interest on money borrowed to finance acquisition transactions that was a key factor in triggering the market crash.

ELIMINATION OF INTEREST DEDUCTIONS

Is the taxpayer subsidizing leveraged buyout activity? Is the use of leverage in restructuring exacerbating the Federal budget deficit?

I am convinced of one thing: Elimination of tax deductibility of interest on acquisition debt will not raise revenues. Instead, it will severely dampen the activity. Fewer deals will take place. Those that do will happen at much lower prices. Those prices might be found with the Dow Jones Industrial Average at 1000. Leveraged buyout activity is, over the long run, "revenue positive" from the vantage point of the U.S. Treasury. First, selling shareholders pay capital gains taxes at the time of the transaction. Moreover, since the general level of stock prices has been raised by the activity, taxes on all stock market capital gains are higher than otherwise would be the case. Second, the major providers of the loans for acquisitions are *themselves* taxpaying entities. Wilson Sporting Goods' deduction is someone else's taxable income. Admittedly, some debt holders are untaxed entities, like pension funds. However, in that case, there is a different public policy issue, unrelated to the fact that the debt was raised to finance an acquisition. The taxes on the high yield bonds held by pension funds *will*, in fact, be paid when the benefits are distributed to pension beneficiaries. Over time, virtually every tax deduction in the economy becomes taxable income to somebody else. If it happens later, rather than sooner, this is the result of public policy designed to stimulate the formation of retirement capital for an aging population.

DEBT VS. EQUITY

One can make many theoretical arguments about whether or not some or all of the debt which finances acquisitions is really equity dressed up as debt. As a sizeable holder of debt instruments created to support leveraged buyouts, I can only say that we believe we own debt, not equity. Our holdings contractually bind the issuer to pay us a coupon and return our principal on specific dates. We enforce our contracts. Some have made the case that LBO debt is really equity because it carries equity-like risks. Does this argument make payments on office building mortgages in Houston nondeductible? It is not risk that should determine whether something is equity or debt. Rather, it relates to ownership and reward.

As debtholders we have none of the privileges of ownership. We do not vote, and we do not share when a company does better than expected. If a company hires a worker to do a job, it pays the agreed upon wage no matter how successful the company becomes. The wage is a deductible cost of doing business. Similarly, high profits in the business do not obligate the manufacturer to pay more for his materials. So, too, with the rent on a corporation's headquarters building.

Simply put, money is just another factor to be rented. If we finance a successful leveraged buyout, the company is not obligated to pay us any more than our bonds allow for. They have rented our money. We expect them to pay for it. If they succeed, as owners, they get the excess. If the company fails, we will insist that the owners feel the first pain.

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[4] Giordano, Robert, "Debt Without Disaster," *Financial Market Perspectives*, Goldman Sachs (Dec. '88/Jan. '89); p. 2

This brings me to one final point, and I believe it is important to this issue: ***The purpose of debt in a leveraged buyout is not capturing the tax advantage***, although it does make transactions more attractive. The purpose is to bring ownership within the financial reach of those who can make the company operate more efficiently. The LBO business is not a business of financial gymnastics. It is a business of people. It is "Capitalism 101". Fantastic things happen when you give a management team a once-in-a-lifetime chance. But very few management teams can accumulate enough capital to own, as a typical example, 20% of a $100 million company. If banks and insurance companies will agree to lend $90 million, it will take only $2 million for the managers to purchase ownership of a 20% slice. A stake in the business that is truly meaningful becomes financially within the grasp of the management team. The purpose of leverage is not the tax deduction. ***The purpose of leverage is to create a wide disparity between the reward for success and the penalty for failure.*** At its roots, this concept is no different from what takes place when a young couple borrows most of the money — a first mortgage from their bank, a second mortgage from a credit company and half the downpayment from their parents — to buy their first home. For many people this becomes the route to the accumulation of most of the capital they will have when they retire. If much of the interest were not tax-deductible, many of the nation's homes would neither be bought nor built.

I am not here to say that the business of doing leveraged buyouts is without flaws. We support prudent legislation to correct certain potential abuses. We are, for example, in favor of regulation to promote the fullest possible disclosure so that shareholders have the information and the time to decide whether to sell their stock. In addition, corporate directors should be held accountable for acting in the best interests of shareholders. We believe the antitrust laws should be reasonably and fairly enforced. We are concerned about the practice of paying fees, which vary with transaction success, to firms that provide "fairness" opinions.

However, on balance, an enormously beneficial process is going on. We urge Congress to do nothing which might thwart this necessary process, resulting in a refined and reshaped American economy.

I thank you for this opportunity to submit my position to the Committee. I am always available to speak with you further on this subject.

United States House of Representatives
Committee on Ways and Means
Hearings on Tax Policy Aspects of
Corporate Financial Structures

January 31 and February 1-2, 1989

Statement submitted by Alan L. Feld

My name is Alan L. Feld. I am a Professor at Boston University School of Law, specializing in Federal income taxes. I am the author of Tax Policy and Corporate Concentration (1982 D.C. Heath & Co.) and other books and articles related to Federal tax issues.

The financial transactions that affect the level of debt and equity in the corporate sector, which constitute the subject of these hearings, raise complex economic and social questions. This statement addresses the relationship between these transactions and the structure and operation of the corporate income tax.

For corporate income tax purposes, the distinction between debt and equity in a corporation's financial structure holds considerable significance. Corporations may deduct interest on debt but not dividends or other distributions with respect to stock. Other tax consequences also flow from treatment of an investment in a corporation as equity or debt; these range from recognition of gain on certain exchanges to measurement of control for affiliated group purposes. The new restructuring transactions focus attention on the general issue of the appropriateness of these distinctions. Proposals to integrate the corporate and shareholder income tax or otherwise to alter radically the corporate tax system, which would eliminate the principal tax consequences of the distinction between debt and equity, also would eliminate the tax preference for debt in restructuring transactions.

This statement lays to one side these broader aspirations for reform of the tax law. It proceeds on the assumption that the present distinctions between corporate debt and equity will continue to have importance and it proposes to deal with restructuring transactions within this framework of existing law.

The debt issued in financial restructuring transactions presents a mix of debt and equity characteristics. Instruments in the form of debt offer investors risks and rewards which resemble those of equity instruments. These instruments present a question of classification: should the tax law treat them as debt or equity.

Despite the longstanding importance of the debt-equity distinction, no definitive set of criteria sharply divides the two. The case law, concerned largely with investment in closely-held corporations, classifies an interest in a corporation on the basis of a long list of characteristics whose weight, number and importance may vary somewhat from court to court. No case appears to have treated debt instruments held by nonshareholders as equity. A protracted effort to deal with the debt-equity matter by regulation under the authority of Code section 385 ultimately proved unsatisfactory.

Without attempting to resolve the entire debt-equity issue, legislation could deal with its manifestation in the corporate restructuring area. Three observations frame the response proposed:

1. Big corporations differ from little ones. The economic and social anxieties generated by financial restructuring transactions focus on the former, not the latter. Differences in markets, borrowing capacity and other relevant financial factors may change the meaning of transactions otherwise identical in form. Any new rules to classify corporate debt as equity in particular circumstances should focus on big corporations only and leave the debt-equity question of smaller corporations for another day.

2. Solutions that turn on a connection between debt and an acquisition or other restructuring transaction will encourage planners and advisers to disguise that connection. Borrowing may occur in anticipation of a tainted transaction, but at a sufficient temporal remove to avoid the proposed nexus. A solution that addresses debt of the corporation without regard to the occasion for its creation seems preferable.

3. Simplicity in conception and execution is to be preferred to a more exact but complex formulation. The result may seem arbitrary in a few cases, but if it is workable and substantially covers the problem the preference seems justified.

The solution I propose meets these criteria. Congress should amend the Internal Rèvenue Code to treat as equity the new debt of large corporations if the debt to equity ratio exceeds a specified level, such as 4:1.

I define a "large" corporation somewhat arbitrarily as one with either gross assets in excess of $100 million or debt whose face amount exceeds $100 million. Fewer than 10,000 corporations would meet this threshhold requirement. An affiliated group would count as one corporation. Borrowings would be tested when incurred. For purposes of meeting the ratio test, the tax books of the corporation should govern, unless the taxpayer can establish different values. An exception for relatively small borrowings, perhaps of under $1 million, seems plausible.

Ratio tests to distinguish equity from debt are not new. For a period after the Supreme Court's decision in John Kelley Co. v. Commissioner, 326 U.S. 521 (1946), a 4:1 ratio became a rule of thumb used by practitioners. Subsequent cases, however, made it clear that courts would look to many other factors as well and the significance of the ratio declined. The regulation project under section 385 also relied on ratios, but the rules also contained many qualifications and subrules. In both instances the use of ratios suffered from two defects: the absence of a statutory requirement establishing the ratio test as determinative; and the need to apply the test to all corporations. The proposal here meets those defects by acting through the statute rather than case law or regulations and by limiting the scope of the requirement to a small percentage of corporate taxapayers.

The proposal would limit the tax advantages of borrowings at the point where they create concerns about the stability of large enterprises and erosion of the corporate tax base. At the same time, the proposal allows for continuation of a market for control of corporations, requiring only that the tax law treat the financial instruments used in the transactions in accordance with their equity characteristics. A simple classification rule to solve the problems of restructuring transactions seems justified.

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Dominick & Dominick Co.

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New York 10004

January 4, 1989

Hon. Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed for the information of the Committee and for inclusion in the printed record of the Committee's hearings on tax policy related to mergers is a table of the prominent uninvited cash tender offers made since March 1977. That was the date of the takeover bid for Babcock & Wilcox, which many regard as the start of the current takeover wave. The table is an updated version of one appearing as an Appendix to my book "The Takeover Dialogues: A Discussion of Hostile Takeovers," Washington Network Press, 1988.

The table demonstrates that "defense" against hostile cash tender offers is a myth. Virtually every target loses its independence or its financial health. This fact stands in contradiction to the popular use of such terms as "takeover defense experts," "level playing field" and the "marketplace" determining whether a proposed acquisition is economically beneficial. To regard hostile takeovers as contests for a company's independence is to misunderstand what's been going on here.

Almost every publicly held company in America, regardless of size, is a potential speculator's windfall at the expense of the U.S. Treasury, courtesy of the interest deduction. My recommendation is that the Committee deny the interest deduction for most kinds of uninvited takeover indebtedness, because it lacks the important checks and balances to be found in debt resulting from negotiated transactions. A relatively simple change in Section 279 would do the job. (Foreign uninvited transactions would have to be subjected to a corresponding equalizing tax.)

The Committee can be sure that other supposed excesses in the merger area (parachutes, "greenmail," restructurings, etc.) will all soon subside once uninvited purchases of stock of public companies with borrowed money are curbed. Moreover companies will still be free to combine via mergers and asset purchases involving acquisition debt, and to do voluntary leveraged buyouts, so this action would not interfere with traditional merger activity and the incidental benefits this may have for the stock markets.

Very truly yours,

Edmund J. Kelly

Edmund J. Kelly
Vice Chairman

Enclosure

Dominick & Dominick Co.

Prominent Uninvited Cash Tender Offers — 1977-1988

DATE	TARGET	BIDDER	TARGET'S INVESTMENT BANKER	TARGET'S TAKEOVER COUNSEL	RESULT (HIGH BID)
3/77	Babcock & Wilcox	United Technologies	Morgan Stanley	Wachtell Lipton	After protracted litigation, B&W became a division of McDermott Incorporated. ($750 M.)
11/77	Carborundum	Eaton Corporation	Morgan Stanley	Skadden Arps	After brief litigation, Carborundum became a division of Kennecott Corporation. ($567 M.)
6/78	Pet Inc.	IC Industries	Morgan Stanley	Fried Frank	Pet became a division of IC. ($375 M.)
9/78	Carrier Corporation	United Technologies	Morgan Stanley	Davis Polk	After protracted litigation, Carrier became a division of Technologies. ($950 M.)
11/78	P.R. Mallory	Dart Industries	First Boston	Simpson Thacher	Mallory became a division of Dart. ($258 M.)

Primary Source: The Wall Street Journal articles. (Does not include offers made after management announced a going private proposal or leveraged restructuring.)

1/89

DATE	TARGET	BIDDER	TARGET'S INVESTMENT BANKER	TARGET'S TAKEOVER COUNSEL	RESULT (HIGH BID)
1/79	McGraw-Hill	American Express	Morgan Stanley	Wachtell Lipton	Offer was withdrawn by American Express before it was actually made, AMEX protesting that it assumed McGraw-Hill management would be receptive to an offer, or else it never would have been announced in the first place. ($1 B.)
4/79	F.W. Woolworth	Brascan	Kidder Peabody	Skadden Arps	Brascan bid was made to dissuade bid by Bronfman interests for control of Brascan itself. The Bronfmans eventually got control of Brascan and stopped the proposed offer before it was officially made. (Prior to the Brascan cancellation, a banker for Woolworth testified in South Carolina that he had been authorized to find a higher bidder for Woolworth.) ($1.1 B.)
10/79	ERC	Connecticut General	Smith Barney	Wachtell Lipton	After protracted litigation, ERC became a divison of Getty Oil. ($570 M.)

DATE	TARGET	BIDDER	TARGET'S INVESTMENT BANKER	TARGET'S TAKEOVER COUNSEL	RESULT (HIGH BID)
3/80	Liggett Group	Grand Met PLC	Merrill Lynch	Skadden Arps	After protracted litigation, Liggett became a division of Grand Met. ($570 M.)
7/80	Pullman Inc.	McDermott Incorporated	First Boston	Skadden Arps	After protracted litigation, Pullman became a division of Wheelabrator-Frye. ($600 M.)
9/80	Crouse-Hinds	Internorth	Lazard Freres	Skadden Arps	After protracted litigation, Crouse-Hinds became a division of Cooper Industries. ($720 M.)
3/81	St. Joe Minerals	Seagram	First Boston Smith Barney	Wachtell Lipton	After protracted litigation, St. Joe became a division of Fluor. ($2.6 B.)
6/81	Conoco	Seagram	First Boston	Skadden Arps	After protracted litigation, Conoco became a division of DuPont. ($6.82 B.)

DATE	TARGET	BIDDER	TARGET'S INVESTMENT BANKER	TARGET'S TAKEOVER COUNSEL	RESULT (HIGH BID)
6/81	Texasgulf	Elf Aquitaine	Morgan Stanley	Skadden Arps	Texasgulf became a division of Elf. ($2.74 B.)
7/81	Connecticut General REIT	British National Coal Board	First Boston	Wachtell Lipton	After protracted litigation, Conn. Gen. REIT became a division of Prudential Insurance. ($340 M.)
9/81	Sunbeam Corp.	IC Industries	Morgan Stanley	Jenner & Block	After protracted litigation, Sunbeam became a division of Allegheny International. ($528 M.)
9/81	Grumman	LTV Corp.	Morgan Stanley	Cahill Gordon	As a result of antitrust litigation by Grumman, LTV was enjoined and withdrew its offer. ($642 M.)
10/81	Marathon Oil	Mobil	First Boston	Skadden Arps	After protracted litigation, Marathon became a division of U.S. Steel. ($6.2 B.)
1/82	Brunswick Corp.	Whittaker Corp.	Lehman Bros. Salomon Bros. Merrill Lynch	Mayer Brown & Platt	Whittaker withdrew after Brunswick sold its key medical unit to American Home Products. Brunswick's CEO resigned 2 months later. ($600 M.)

DATE	TARGET	BIDDER	TARGET'S INVESTMENT BANKER	TARGET'S TAKEOVER COUNSEL	RESULT (HIGH BID)
3/82	Joseph Schlitz Brewing Co.	Stroh Brewing Co.	Goldman Sachs	Cleary Gottleib	After brief litigation, Schlitz became a division of Stroh. ($316 M.)
6/82	Cities Service	Mesa Petroleum Co.	First Boston Lehman Bros.	Wachtell Lipton	After protracted litigation, and an abortive $4.8B acquisition agreement with Gulf Oil, Cities Service became a division of Occidental Petroleum Corporation. ($4 B.)
8/82	Martin Marietta Corporation	Bendix Corporation	Kidder Peabody	Dewey Ballantine	After protracted litigation, and a bid by Martin for a majority of Bendix, Allied Corporation acquired Bendix for $1.9B and Martin remained independent, but with 39% of its stock owned by Allied and $400M in equity (down from $1.2B.)
12/82	El Paso Company	Burlington Northern Inc.	Merrill Lynch	Wachtell Lipton	After brief litigation, El Paso became a division of Burlington. ($516 M.)

DATE	TARGET	BIDDER	TARGET'S INVESTMENT BANKER	TARGET'S TAKEOVER COUNSEL	RESULT (HIGH BID)
12/82	General American Oil Company of Texas	Mesa Petroleum	First Boston	Wachtell Lipton	General American became a division of Phillips Petroleum Co. ($1.14 B.)
6/83	Lenox Inc.	Brown-Forman Distillers Corp.	Kidder Peabody	Wachtell Lipton	After brief litigation, Lenox became a division of Brown-Forman. ($427 M.)
6/83	Texas Gas Resources Corporation	Coastal Corporation	First Boston	Cahill Gordon	Texas Gas became a division of CSX. ($1.1 B.)
12/83	Getty Oil Co.	Pennzoil Co.	Goldman Sachs	Dechert Price	Getty became a division of Texaco. ($10 B.)
1/84	Houston Natural Gas Corporation	Coastal Corporation	First Boston	Wachtell Lipton	After brief litigation and a $900 M bid by Houston for all of Coastal, Coastal withdrew its offer, as did Houston, in return for $42.1 M "peace payment" by Houston and a 5 year put to Houston of about one-fourth of Coastal's gas production at a 30% premium over the price of regulated gas. ($1.3 B.)

DATE	TARGET	BIDDER	TARGET'S INVESTMENT BANKER	TARGET'S TAKEOVER COUNSEL	RESULT (HIGH BID)
2/84	Gulf Oil	Mesa Petroleum Co.	Lehman Bros. Merrill Lynch	Sullivan & Cromwell	Gulf became a division of Standard Oil Co. of California. ($13.4 B.)
4/84 and 11/86	Carter Hawley Hale Stores	The Limited and DiBartolo	Morgan Stanley	Skadden Arps	CHH became 47.3% owned by General Cinema.
11/84	Prentice-Hall	Gulf & Western	Dillon Read	Cravath	Prentice-Hall became a division of Gulf & Western. ($695 M.)
12/84	Scovill	Belzbergs	Morgan Stanley Morgan Lewis Githens & Ahn	Skadden Arps Shearman & Sterling	Scovill became a subsidiary of the Belzbergs. ($516 M.)
12/84	Phillips Petroleum	Icahn	First Boston Morgan Stanley	Wachtell Lipton	After protracted litigation involving first Pickens and then Icahn, Phillips restructured, inverting its debt to equity ratio.
3/85	American Natural Resources	Coastal	First Boston Goldman Sachs	Wachtell Lipton	ANR became a division of Coastal. ($2.5 B.)
4/85	Uniroyal, Inc.	Icahn	Salomon Brothers	Wachtell Lipton	Uniroyal became a division of a private company. ($836 M.)

DATE	TARGET	BIDDER	TARGET'S INVESTMENT BANKER	TARGET'S TAKEOVER COUNSEL	RESULT (HIGH BID)
4/85	Unocal	Mesa Partners II	Dillon Read and Goldman Sachs	Gibson Dunn & Crutcher Wilmer Cutler & Pickering	Unocal restructured, inverting its debt to equity ratio.
4/85	Crown Zellerbach Corp.	General Oriental Securities Ltd. (Sir James Goldsmith)	Salomon Bros.	Wachtell Lipton Sullivan & Cromwell	Crown became a majority owned subsidiary of General Oriental.
5/85	AMF	Minstar, Inc. (Irwin Jacobs)	Morgan Stanley Morgan Lewis Githens & Ahn	Skadden Arps	AMF became a division of Minstar. ($632 M.)
5/85	Trans World Airlines Inc.	Icahn	Salomon Bros.	Skadden Arps	TWA became a majority owned subsidiary of Icahn. ($795 M.)
5/85	Revlon, Inc.	Pantry Pride	Lazard Freres	Wachtell Lipton Paul Weiss	After brief litigation, Revlon became a division of Pantry Pride. ($2.2 B.)
8/85	SCM Corp.	Hanson Trust PLC	Goldman Sachs	Wachtell Lipton	After brief litigation, SCM became a division of Hanson Trust. ($811 M.)

DATE	TARGET	BIDDER	TARGET'S INVESTMENT BANKER	TARGET'S TAKEOVER COUNSEL	RESULT (HIGH BID)
9/85	Richardson-Vicks Inc.	Unilever N.V.	Kidder Peabody	Skadden Arps	After brief litigation, Richardson-Vicks became a division of Procter & Gamble. ($1.24 B.)
10/85	Pacific Lumber	Maxxam Group	Salomon Bros.	Wachtell Lipton	Pacific Lumber became a division of Maxxam. ($870 M.)
10/85	Cluett-Peabody	Bilzerian	Goldman Sachs	Sullivan & Cromwell	After brief litigation, Cluett-Peabody became a division of West-Point Pepperell. ($375 M.)
10/85	Hoover Co.	Chicago Pacific	Lazard Freres	Wachtell Lipton	Hoover Co. became a division of Chicago Pacific. ($533 M.)
10/85	Transway International	Nortek Inc.	Kidder Peabody	Wachtell Lipton	After brief litigation, Transway became a division of International Controls Corp. ($322 M.)
10/85	Southland Royalty	Burlington Northern	Goldman Sachs	Skadden Arps	Southland Royalty became a division of Burlington Northern. ($715 M.)
10/85	Potlatch	Belzbergs	Goldman Sachs	Skadden Arps	Offer was withdrawn by Belzbergs before it was actually made, when Potlatch repurchased Belzbergs' stake. No litigation filed by Potlatch and suggestions that Belzberg offer was proposed to prompt a buyback.

DATE	TARGET	BIDDER	TARGET'S INVESTMENT BANKER	TARGET'S TAKEOVER COUNSEL	RESULT (HIGH BID)
12/85	Midcon Corp.	Wagner & Brown, Freeport McMoran	Merrill Lynch	Sullivan & Cromwell	Midcon became a division of Occidental Petroleum ($3 B.)
2/86	White Consolidated	AB Electrolux	Goldman Sachs	Jones, Day	White Consolidated became a division of Electrolux. ($742 M.)
5/86	Sperry Corp.	Burroughs	First Boston	Skadden Arps	Sperry became a division of Burroughs. ($4.4 B.)
5/86	Saga Corp.	Marriott	Goldman Sachs	Orrick, Herrington Sutcliffe	Saga became a division of Marriott. ($502 M.)
5/86	John Blair & Co.	McFadden Holdings	Salomon Bros. Drexel Burnham	Cravath	Blair became a division of Reliance Capital. ($250 M.)
6/86	Associated Dry Goods	May Department Stores	Shearson Lehman Goldman Sachs	Skadden Arps	Associated Dry Goods became a division of May. ($2.5 B.)
6/86	Sanders Associates	Loral Corp.	Kidder Peabody	Debevoise & Plimpton	Sanders became a division of Lockheed. ($1.8 B.)
6/86	Fruehauf Corp.	Asher Edelman	Kidder Peabody	Shearman & Sterling	Fruehauf became a division of Merrill Lynch. ($1.4 B.)
7/86	Hammermill Paper	Paul Bilzerian	First Boston Morgan Stanley	Skadden Arps	Hammermill became a division of International Paper. ($1.1 B.)

DATE	TARGET	BIDDER	TARGET'S INVESTMENT BANKER	TARGET'S TAKEOVER COUNSEL	RESULT (HIGH BID)
7/86	NL Industries	Harold Simmons	First Boston Dillon Read	Wachtell Lipton	NL became a majority owned subsidiary of Simmons. ($450 M.)
8/86	Ex-Cell-O	Textron	Goldman Sachs	Fried Frank	Ex-Cell-O became a division of Textron. ($1.05 B.)
8/86	Owens-Corning Fiberglas Corp.	Wickes Cos.	Goldman Sachs	Skadden Arps Debevoise Plimpton	Owens-Corning restructured, inverting its debt to equity ratio.
9/86	Ryan Homes, Inc.	NV Homes LP	Shearson Lehman	Fried Frank Skadden Arps	Ryan became a division of NV Homes. ($312 M.)
9/86	Allied Stores Corp.	Campeau Corp.	Goldman Sachs	Sullivan & Cromwell	After brief litigation Allied became a division of Campeau. ($3.6 B)
11/86	Gillette Co.	Revlon Group Inc.	Morgan Stanley	Skadden Arps	Revlon's 14% stake was repurchased, resulting in a doubling of Gillette's debt.

DATE	TARGET	BIDDER	TARGET'S INVESTMENT BANKER	TARGET'S TAKEOVER COUNSEL	RESULT (HIGH BID)
11/86	Chesebrough-Ponds	American Brands	Shearson Lehman	Skadden Arps	Chesebrough-Ponds became a division of Unilever. ($3.1 B.)
11/86	Lane Co.	Interco	Goldman Sachs	Wachtell Lipton	Lane became a division of Interco.($487 M.)
11/86	Joy Manufacturing Co.	Pullman-Peabody Co.	First Boston	Fried Frank	Joy Manufacturing became a division of a private company. ($620 M.)
2/87	Cyclops Corp.	Audio/Video Affiliates, Inc. and Citicorp Capital Investment Ltd.	Goldman Sachs	Kirkpatrick & Lockhart	Cyclops became a division of Dixons Group PLC. ($393 M.)
2/87	ChemLawn Corp.	Waste Management Inc.	Smith Barney	Fried Frank	ChemLawn became a division of Ecolab. ($370 M.)
3/87	GenCorp.	AFG Industries Inc. and Wagner & Brown	Kidder Peabody First Boston	Sullivan & Cromwell; Jones, Day	After protracted litigation, GenCorp repurchased 54% of its shares, inverting its debt to equity ratio.

DATE	TARGET	BIDDER	TARGET'S INVESTMENT BANKER	TARGET'S TAKEOVER COUNSEL	RESULT (HIGH BID)
3/87	Caesar's World, Inc.	Martin Sosnoff	Drexel Burnham	Skadden Arps	Sosnoff's bid was enjoined pending disclosure of his personal finances. He declined to proceed in the face of a Caesar's leveraged restructuring. Later a casino commission barred the restructuring due to "staggering debt." ($1.1 B.)
4/87	Burlington* Industries	Asher Edelman and Dominion Textile	First Boston	Davis Polk	After brief litigation Burlington became a division of Morgan Stanley Group. ($2 B.)
6/87	Reichhold Chemicals Inc.*	Dainippon Ink & & Chemicals Inc.	First Boston	Sullivan & Cromwell	Reichhold became a division of Dainippon. ($600 M.)
6/87	JWT Group Inc.	WPP Group PLC	Morgan Stanley	Sullivan & Cromwell	JWT became a division of WPP. ($566 M.)
8/87	Manpower Inc.	Blue Arrow PLC	Morgan Stanley	Godfrey & Kahn Morris Nichols	Manpower became a division of Blue Arrow. ($1.3 B.))
8/87	ADT, Inc.	Hawley Group Ltd.	Goldman Sachs	White & Case	ADT became a division of Hawley. ($715 M.))
8/87	Kenner Parker Toys, Inc.*	New World Entertainment, Ltd.	Goldman Sachs Dillon, Read	Ropes & Gray Wachtell Lipton	Kenner became a division of Tonka Corporation. ($630 M.)

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*From 4/87 an (*) indicates target had poison pill.

DATE	TARGET	BIDDER	TARGET'S INVESTMENT BANKER	TARGET'S TAKEOVER COUNSEL	RESULT (HIGH BID)
9/87	Newmont Mining Corp.*	Ivanhoe Partners (Pickens et al.)	Kidder Peabody Goldman Sachs	Wachtell Lipton White & Case	Newmont became a 49.7% sub of Consolidated Gold Fields PLC ($2.7 B.)
9/87	G. Heileman Brewing Co.*	Bond Corp. Holdings	Merrill Lynch	Foley & Lardner Wachtell Lipton	Heileman became a division of Bond. ($1.3 B.)
10/87	Telex Corporation*	Asher Edelman	Drexel Burnham	Cahill Gordon	Telex became a division of Memorex International. ($911 M.)
11/87	Singer Co.	Bilzerian	Goldman Sachs	Winthrop Stimson Skadden Arps	Singer became a division of Bilzerian's Company. ($1.0 B.)
12/87	Computervision Corporation*	Prime Computer	Goldman Sachs	Skadden Arps	Computervision became a division of Prime. ($435 M.)
1/88	Sterling Drug Inc.	Hoffmann-La Roche	Morgan Stanley	Skadden Arps	Sterling became a division of Kodak. ($5.1 B.)
1/88	American Standard*	Black & Decker Corp.	Goldman Sachs	Sullivan & Cromwell	After brief litigation American became a division of Kelso & Co. ($2.5 B.)
1/88	IU International Corp.*	Neoax Inc.	First Boston Goldman Sachs	Wachtell Lipton	IU became a division of Neoax. ($671 M.)
1/88	Federated Department Stores Inc.*	Campeau Corp.	Shearson Lehman	Skadden Arps	Federated became a division of Campeau. ($6.6 B.)

DATE	**TARGET**	**BIDDER**	**TARGET'S INVESTMENT BANKER**	**TARGET'S TAKEOVER COUNSEL**	**RESULT (HIGH BID)**
2/88	Stop & Shop Cos.*	Dart Group Corp.	Shearson Lehman	Simpson Thacher	Stop & Shop became a division of Kohlberg Kravis Roberts & Co. ($1.2 B.)
3/88	Koppers Co.*	Beazer PLC	First Boston	Skadden Arps	After extensive litigation Koppers became a division of Beazer. ($1.7 B.)
3/88	Grolier Inc.*	Hachette S.A.	First Boston	Wachtell Lipton	Grolier became a division of Hachette. ($450 M.)
3/88	Lucky Stores Inc.*	American Stores Inc.	Goldman Sachs	Fried Frank	Lucky became a division of American. ($2.5 B.)
3/88	Farmers Group	BAT Industries PLC	First Boston Morgan Stanley	Gibson Dunn	After protracted litigation Farmers became a division of BAT. ($5.2 B.)
4/88	Staley Continental Inc.*	Tate & Lyle PLC	First Boston	Skadden Arps	Staley became a division of Tate & Lyle. ($1.5 B.)
7/88	Macmillan Inc.*	Robert Bass Group	First Boston Wasserstein	Weil Gotshal	After brief litigation Macmillan became a division of Maxwell Communications. ($2.4 B.)

DATE	TARGET	BIDDER	TARGET'S INVESTMENT BANKER	TARGET'S TAKEOVER COUNSEL	RESULT (HIGH BID)
7/88	Interco*	Rales Brothers	Goldman Sachs Wasserstein	Wachtell Lipton	Interco restructured, inverting its debt to equity ratio.
9/88	Polaroid*	Disney	Shearson Lehman	Cravath	Pending
10/88	Pillsbury*	Grand Met PLC	First Boston Shearson Lehman Drexel Burnham Wasserstein	Skadden Arps	After protracted litigation, Pillsbury became a division of Grand Met. ($5.7 B.)
10/88	Kraft, Inc.*	Phillip Morris	Goldman Sachs	Wachtell Lipton	Kraft became a division of Phillip Morris. ($13.1 B.)
10/88	Holly Farms*	Tyson Foods	Morgan Stanley	Wachtell Lipton	Pending
10/88	West-Point Pepperell*	Farley Inc.	Merrill Lynch Goldman Sachs	Wachtell Lipton	Pending
11/88	Prime Computer*	MAI Basic Four	Smith Barney First Boston	Wachtell Lipton Hale and Dorr	Pending
12/88	Pennwalt*	Centaur Partners	Goldman Sachs	Dechert Price	Pending

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January 13, 1989

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I enclose a copy of a letter I received from Chairman Rostenkowski. I would be pleased to have included in the printed record of the hearing my article from the New York Times. I enclose a copy, and would be most appreciative of your including it.

With all good wishes,

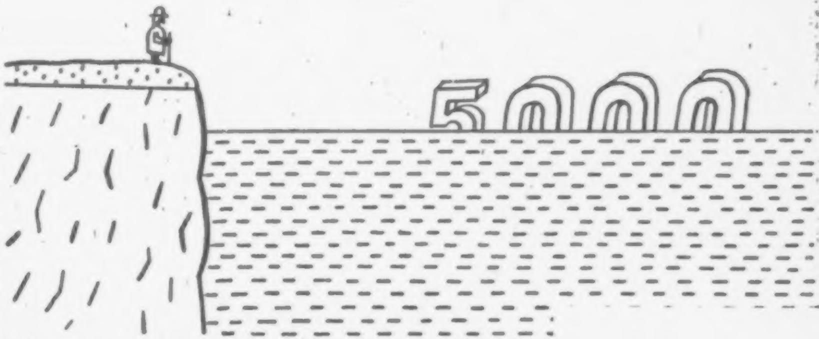
Sincerely,

Newton N. Minow, P.C.

Enclosures

The Free-Market Blather Behind Takeovers

By Newton N. Minow
and David R. Sawyier



Let's reward long-term investment, not short-term thinking

CHICAGO

That insightful comedian Henny Youngman once remarked: "I have all the money I need for the rest of my life — provided I die by 4 o'clock this afternoon."

Too many American businesses seem to be adopting this 4 P.M. planning horizon. A whole new jargon has entered board rooms, courtrooms, hearing rooms and union meeting halls. The new vocabulary includes not only such familiar phrases as "poison pills," "greenmail," "junk bonds" and "golden parachutes" but also polysyllabic newcomers such as "paper entrepreneurs," "maximizing shareholder values" and "entrenching corporate managements."

What this language relates to is the extraordinary wave of takeover attempts in this country and the ingenious defenses erected against them. The best business minds in the country are preoccupied with this trend. In a real sense, we have a "brain drain" diverting us from the development of new products, technologies and jobs, and focusing instead on the quick and easy profits to be made by corporate takeovers. We are putting our energies not into the long-term health of the nation but into short-run gains — by 4 o'clock in the afternoon, if possible.

When one asks why, the answer reminds one of Willie Sutton's response when asked why he robbed banks: That, he said, is where the money is. Legal and investment banking fees on one takeover alone recently reached $100 million. While great wealth is exchanged in such transactions, none is produced. Debt formation is invoked; capital formation is out of style.

When questions are raised about such feverish activity (822 publicly announced merger and tender offers worth $161.5 billion so far in 1985), proponents say that takeovers increase shareholder wealth and that market forces should govern our economic decision-making. If there is a disparity between the low stock market price and asset value of a corporation, the shareholders deserve more for their investment. Moreover, the market should be permitted to pass control to managers who, the argument goes, will do better for investors.

Fair enough. If we believe in the marketplace (and a "free" economy is very much part of the American system), we should encourage the market to do its work without the intervention of antimarket do-gooders concerned with such nostalgic intangibles as the preservation of communities and long-standing businesses rather than instant cash.

But these "free marketeers" should at least be honest with themselves and with us. For the market

Newton N. Minow is a Chicago lawyer who serves on various corporate boards. David R. Sawyier specializes in corporate and commodities law.

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they celebrate is not really all that free. It is a market that has already been interfered with, that has been created in part by regulation and that in turn has tilted our economy toward short- rather than long-term thinking and caused it to be overleveraged and undermanaged. Take the following illustrations.

First, it is the tax law, not the market, that decrees that interest on debt is tax deductible while dividends on equity are not. The different tax treatment of interest and dividends encourages businesses to borrow rather than raise permanent capital, and has done much to encourage acquisitions. Corporate debt now exceeds the total net worth of our corporations, and the current system continues to induce management to substitute debt for equity.

Second, it is the tax law, not the market, that prescribes that some investors — for example, pension funds — should not pay taxes while others do. The result is that money managers for pension funds and other institutional investors have become some of the heaviest hitters in the market, speculating and trading in stocks for short-term profit. By allowing these institutions to realize short-term gains without the usual tax constraints, the system encourages short-term speculation rather than long-term investment.

Third, it is a combination of state corporation law and stock exchange policy, not the market, that says that a stockholder can vote as soon as he buys a company's stock. This means that someone who owns a stock for only a few days and intends to dispose of it as soon as he profitably can is in a position to dismantle an enterprise that has taken a generation to build.

Fourth, it is the Securities and Exchange Commission and the stock exchanges, not the market, that prescribe quarterly reporting of earnings by public companies. The purpose of this rule was to give investors access to timely information, a sound idea. But reporting results on a 90-day cycle is often purely arbitrary, and shrinks the perspective of management to the next S.E.C. form.

These are the kinds of issues that need debate now. While some takeovers are good and others bad, a system that rewards short-term thinking is always bad. Nor should we waste time talking about the sanctity of the free market when the markets are what we choose them to be.

Let's begin instead to consider ways of encouraging long-term investment. Tax policy seems a good place to start. One obvious change would be to reduce taxes on long-term gains while gradually increasing taxes on gains of shorter duration: for example, a 5 percent tax on sales of stock held five years, increasing to 50 percent on sales of stocks held five minutes.

What we now have is a market reacting to man-made regulations, tilting American business in a dangerous direction. Our best minds should be focused on reversing this direction, as the Federal Reserve Board is beginning to do with its proposal to increase the amount of capital a corporate suitor must put up in any takeover attempt.

The proverbial difference between a politician and a statesman is that one thinks about the next election while the other thinks about the next generation. We need more business statesmen who see beyond maximizing their stock prices by 4 o'clock in the afternoon.

Otherwise, we will leave our children the most bitter poison pill of all: a nation whose productive enterprises are worth more dead than alive. □

PIONEER BANK

R. LARSON MICK
Vice President
Trust Officer

December 29, 1988

Mr. Robert J. Leonard
Chief Counsel
Committee On Ways & Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Re: Ways & Means Press Release #30 dtd 12/6/88
Tax Policy Aspects of Mergers & Acquisitions

Dear Sir:

I appreciate the chance to submit a written statement regarding the subject of the upcoming hearing on Tax Policy Aspects of Mergers & Acquisitions. I believe it is unfortunate that companies which have accumulated valuable assets find themselves vulnerable to raiders who "enhance" the value for shareholders. Not all shareholders want their values "enhanced" to where they are forced to take high profits and capital gains, then pay tax at 28% or more on capital gains and begin investment program over with 72% of their enhanced value.

But I am concerned that Congress may try to fix faulty corporate law via a tax policy. In my opinion, part of the current problem is due to tax policy - double tax on dividend payments. Therefore, tax policy has encouraged corporate management to retain cash and try to make the stock grow in value without current tax payments. In my opinion, what we do not need is more detailed tax incentives or disincentives for particular business decisions. What we need, in my opinion, is more and more tax neutrality at the business decision level.

I believe far greater fairness will be achieved if tax consequences were neutral as between business arrangements - corporations, partnerships, limited partnerships, sole proprietors, etc. Why does Congress have to try to manipulate business decisions, particularly in knee-jerk "incentive" fashion? Lawyers, accountants and business men will shape arrangements to take advantage of incentives; the arrangements then go to extremes but still legal; then they're labeled as loopholes and finally a new part of the tax law is born to disincentive the incentives.

Therefore, if anything other than state corporation statutes needs fixing, I'd propose the ultimate simplification - tax neutrality. If interest payments are deductible, let dividend distributions be deductible. Partnership earnings are taxed at partner level only; let dividends be taxed at shareholder level only.

Adjust corporate and shareholder and trust tax rates to be neutral. Then adjust the rate structure to collect the same amount of money needed to run the government.

Thank you.

Sincerely,

R. Larson Mick

R. Larson Mick

801 BROAD STREET • CHATTANOOGA, TENNESSEE 37402 • 615/265-2551

12/15/88

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The Research
Institute of
America, Inc.

1 — Ways and Means to hold hearings on tax policy aspects of mergers and acquisitions

House Ways and Means Chairman Rostenkowski has announced that the Committee will hold a series of hearings on the tax policy issues with respect to mergers, acquisitions, leveraged buyouts and recent increases in corporate debt, generally. The hearings are scheduled to begin on Jan. 31, '89.

The Committee wants to determine the effect of these transactions on the companies being purchased and the financial and other investors who are providing capital for the purchases, and to examine the long-term consequences of the dramatic increase in corporate debt. Of particular interest to the Committee is the degree to which the tax code encourages and facilitates the financing of these purchases, as well as large increases in debt, generally.

The Committee is seeking public testimony on the following issues:

(1) Tax policy concerns raised by recent transactions, including the implications of the replacement of equity with debt, the impact on economic stability, the effect upon corporate tax receipts, the involvement of tax-exempt investors, including pension plans, ESOPs, and others, the involvement of foreign investors, and the role of banks and savings and loan institutions;

(2) Possible legislative options responding to these tax policy concerns, including proposals to reduce the present bias toward debt;

(3) Proposals designed to encourage incentives for equity formation, such as a dividends-paid deduction.

Individuals and organizations interested in testifying must submit requests by Jan. 4, '89. Persons submitting written statements for the printed record should submit at least 6 copies to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Wash., D.C. 20515. (Ways and Means Press Release #30, 12/6/88)

How can there be stability when tax policy (which shapes business policy) changes every year or so.

if tax structures are neutralized this ought to take care of itself. Lopsided tax policy creates distorted results.

let investors find the best current investments; at most limit gov't guarantees for investors who go into risky investments, this might shift liability for bad decisions to trustees who make the bad decisions.

this will lead to abuses that will turn into loopholes that will then require more tax legislation to correct — just like IRA's. IRA's were so good at encouraging saving Congress had to virtually shut them down — hardly stability.

Neutralize the tax rate + tax policy; see Sept of my letter. Then adjust the tax rate to raise the tax collections to Graham Rudman guidelines or whatever budget agreement Congress + Admin. work out — more gradually so we don't have big shock waves.

CORPORATE TAKEOVERS TAKE THEIR TOLL ON AMERICA

Testimony of PHILIP R. WARTH, JR.

President and Chief Executive Officer of Second Harvest

Before the House Ways and Means Committee
on February 2nd, 1989 at 10 a.m.

My name is Philip R. Warth, Jr., and I am President and Chief Executive Officer of Second Harvest, the national food bank network, headquartered in Chicago, Illinois.

On behalf of the 201 food banks in the Second Harvest network, I would like to thank Chairman Rostenkowski and the Committee for giving me this opportunity to present my thoughts and concerns on corporate takeovers. Second Harvest food banks now distribute food and grocery products to America's poor and working poor at a rate of over one million meals per day, a rate that is second only to the government.

Since Second Harvest began 10 years ago, we have grown from a loose-knit handful of food banks, to a highly organized national network which will soon celebrate the distribution of its second billionth pound of food.

We take great pride in our tremendous growth and accomplishments. But just as we have tugged and struggled to banish hunger from this great nation, other forces in society and the economy have tugged just as strongly in the other direction. No one is trying intentionally to make proverty more widespread or its ravages more bitter, but such is the unrealized potential of runaway corporate takeovers.

Second Harvest and its food banks rely on some 300 national corporations and a multitude of regional and local firms for the food and financial support it takes for us to feed millions of poor Americans whose needs are beyond the government's reach. We need those firms to be healthy and philanthropic today. And perhaps even more importantly, we need them and the rest of the economy to be even healthier in the future, not to increase our programs, but rather to do the opposite: to create circumstances and conditions that allow for more jobs and housing so that food banks will become less needed tomorrow than they are today.

Corporate takeovers do not involve only corporate management, investors, Wall Street and Congress. All Americans are at risk from the effects of the current takeover climate.

Takeovers affect our ability to remain competitive in the international economy, the way in which we address the social needs of our communities, our system of taxation and the well-being of our entire financial system.

While takeovers need not be inherently bad, those that are "hostile" in nature, that rely primarily on borrowed capital or that require the liquidation of companies, are doing great harm to our society. The cultural, economic and financial ramifications of takeovers will, in most cases, have long lasting negative consequences for all of us.

Specifically, those takeovers that fit the profile outlined above generate negative fallout in at least four key respects:

1. They directly and indirectly create economic hardship.
2. They handicap private sector responses to social needs.
3. They exert a negative impact on the economy generally.
4. They threaten the long-term well being of the free enterprise system.

Let me illustrate each concern:

(1) Takeovers directly and indirectly create economic hardship:

Takeovers often result in lay-offs, shut-downs and wage reductions, both in the purchased firm and in the communities and related firms which relied on it. Likewise, by absorbing billions and billions of dollars of available credit, they are keeping interest rates artificially high, which undoubtedly is a factor in the estimated 36,000 farm foreclosures the Agriculture Department is now forecasting. Both impacts take productive workers out of the workplace and add to the ranks of those needing assistance from the public or private sector.

At the same time, those same extraordinarily high interest rates are increasing housing costs for homeowners and renters alike, which, in turn, increases the ranks of the homeless and of those who have housing but, having had to choose between paying the rent or eating, then must seek food assistance to live on.

If the $250 billion used to finance corporate takeovers was made available in the mortgage lending market, mortgage interest rates would drop precipitiously, permitting more Americans to become homeowners and greatly relieving pressure on available rental housing supplies, resulting in lower housing costs for Americans across the board.

The traditional rule of thumb in our society has been that 25 to 30% of a family's income should go to shelter. That figure has grown to over 40%, primarily because of excessively high interest rates. For those 32 million Americans living below the poverty level, a savings of $50 per month in rent could make the difference between going hungry and being adequately fed.

(2) Takeovers handicap private sector responses to social needs:

A critical element in the progress of American Society since World War II has been the concept of "Corporate Citizenship." In recent years, business and social commentators alike have cited the strong correlation between corporate citizenship and corporate excellence. By acknowledging that corporations have a function other than making money for their stockholders, corporations have, through their leadership and financial support, made immeasurable contributions to education, the arts, medical research and social issues.

This citizenship, however, is threatened when a company is highly leveraged, often resulting in little or no available funding for philanthropic activities; elimination of non-revenue producing corporate staff positions, such as community and consumer affairs and trade relations positions; and, in the case of a merger, the elimination of one corporate foundation.

These changes place the concept of "private sector initiative," which has been the basis for numerous federal budget decision since 1980, at genuine risk. As part of the Reagan administration's program for cutting back the government's involvement in meeting social needs, special incentives were provided to business, including lower tax rates, with the understanding that such activities would foster "private sector initiatives." As a result of takeovers, corporate giving has now flattened, and as previously noted, corporations are increasingly diverted from the non-financial roles which they play in society.

That impacts all private sector charities, but additionally, in the specific instance of Second Harvest and private sector efforts to feed the needy, government has traditionally encouraged private industry to donate food for charitable purposes by giving donors special tax incentives.

When debt resulting from a takeover zeros out a corporation's tax liability, that incentive is eliminated and is replaced with a fixation on "the bottom line" that threatens to substantially reduce product contributions from the private sector at a time when charity food agencies are already reeling from the very substantial reductions in TEFAP commodities the Agriculture Department now makes available.

(3) Takeovers exert a negative impact on the economy generally:

Highly leveraged corporate takeovers undermine our competitive position in the world economy by discouraging companies from investing in research and development activities, discouraging long-term business strategies that do not produce immediate positive cash flow, and focusing energies strictly on financial management at the expense of innovation and international marketing.

In addition, the excessive debt resulting from corporate takeovers is unnecessarily exposing our country and all of its citizens to great risk in the event of a significant economic downturn. Given the unprecedented use of debt to finance business, we are building a house of cards ready to collapse. The prospect for business failures increases immeasurably and the entire financial system becomes much more fragile given the current takeover climate.

(4) Takeovers threaten the long-term well being of the free enterprise system:

The corporate takeover binge threatens ultimately to undermine the public support of our free enterprise system. As it becomes apparent that business and corporations no longer aspire to participate in serving the public good and as it becomes more and more obvious to the general public that a few individuals are prospering due to "cleverness" rather than hard work and innovation, cynicism will spill into all areas of our society. The general public will be less tolerant of business, and less understanding of the important role that it has played in our society, and certainly less sympathetic to its needs.

In summary, it seems clear that the short-term narrow financial interests of the few individuals who are profiting from the current corporate takeover binge are completely outweighed by the very significant negative impact those takeovers are having on America and its economy.

I am certain that the private sector in general and Second Harvest in particular will continue working to meet the needs of Americans in poverty no matter what happens, but our load will seem lighter if we can see a light at the end of the tunnel. Corporate takeovers are clouding that light and making the ground under our feet slippery, and that just isn't the way to achieve a kinder and gentler America.

On behalf of the Second Harvest Network and the 32 million Americans who now live in poverty, I urge you to take this takeover bull by the horns and either tame it or control it so as to channel the energies of our wonderful free enterprise system in ways that are not so clearly self-destructive and self-defeating. Your action will:

- keep more workers working and paying taxes;
- keep more farmers farming and producing needed food;
- keep more corporations paying their fair share of taxes;
- permit the marketplace itself to ease the housing crisis;
- permit food banks to handle maximum food supplies while government itself more freely shoulders its share of the anti-hunger burden;
- permit corporate America to resurrect and expand its philanthropic traditions;
- give the economy a genuine boost by lowering interest rates;
- and, perhaps more importantly, will significantly reduce the likelihood of a speculation-driven economic collapse.

# # #

Small
Business
Legislative
Council®

February 9, 1989

The Honorable Dan Rostenkowski
Chairman
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

On behalf of the Small Business Legislative Council, I wish to submit these brief comments, for the record, of your hearings on leveraged buy-outs (LBOs). The Small Business Legislative Council (SBLC) is a permanent, independent coalition of over ninety trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of over four million small businesses in manufacturing, retailing, distribution, professional and technical services, construction, transportation and agriculture. A list of our members is attached.

While we make no pretense of having the resources to participate fully in the debate regarding whether LBOs should be discouraged, or the appropriate method to limit them if such a goal is deemed worthwhile, we do have a significant stake in the outcome. In particular, we do know that small business does rely heavily on debt financing throughout its lifespan. I can recall, during the many go-rounds regarding the regulations under Internal Revenue Code Section 385, the difficulties in finding an adequate definition to reflect the realities of small business financing.

If Congress considers an approach based on the disallowance of interest, we hope you will make a distinction that will allow small business to continue to use the only source of financing readily available to small business, debt.

We cannot pass the opportunity by without commenting on small business' access to capital. Certainly, a small business sector less reliant on debt would be a more preferable situation. Congress can use this opportunity to enact initatives to reduce small business' reliance on debt, and to stimulate the ready flow of venture capital. Restoration of a capital gains differential, perhaps limited to certain assets and adjusted to reflect the duration of the investment, would improve the equity picture for small business.

1025 Vermont Avenue, NW/Suite 1201/Washington, D.C. 20005/(202) 639-8500

Second, we have long been supporters of the Corporation for Small Business Investment (COSBI), the time for implementation of the concept is long overdue. It will increase the availability of venture capital, and resolve a long-standing budget dilemma.

Finally, small business was involved in an extensive debate held in the Judiciary Committee on the impact of mergers and acquisitions in the late 1970's. Granted, LBOs are but one method of corporate restructuring, but we believe some of the observations applicable then, apply now. Economic diversity is a sound concept whether viewed from the national or local perspective. We must encourage it, not discourage it. While it may be true that a by-product of some LBOs are "new" small businesses spawned from the assets shed by the debt-ladened company, on the whole we must view with suspicion any significant concentration of economic power and any method of restructuring that creates such a concentration.

In sum, it is our hope that Congress will consider, in the course of its deliberations on LBOs, what will the impact be of the problem, and solutions, upon small business.

Sincerely,

John S. Satagaj
President

JSS/S0034
Enclosure

SMALL BUSINESS
LEGISLATIVE
COUNCIL

Members of the Small Business Legislative Council

Air Conditioning Contractors of America
Alliance of Independent Store Owners and Professionals
American Association of Nurserymen
American Collectors Association, Inc.
American Consulting Engineers Council
American Council of Independent Laboratories
American Dental Trade Association
American Floorcovering Association
American Machine Tool Distributors Association
American Road Transportation Builders Association
American Society of Travel Agents, Inc.
American Sod Producers Association
American Subcontractors Association
American Textile Machinery Association
American Trucking Associations, Inc.
American Warehousemen's Association
Architectural Precast Association
Associated Builders & Contractors
Associated Landscape Contractors of America
Association of Physical Fitness Centers
Association of Small Business Development Centers
Association of the Wall and Ceiling Industries-International
Automotive Service Association
Building Service Contractors Association International
Business Advertising Council
Christian Booksellers Association
Council of Fleet Specialists
Electronics Representatives Association
Florists' Transworld Delivery Association
Helicopter Association International
Independent Bakers Association
Independent Bankers Association of America
Independent Medical Distributors Association
Independent Sewing Machine Dealers Association
International Association of Refrigerated Warehouses
International Bottled Water Association
International Communications Industries Association
International Fence Industry Association
International Franchise Association
Latin American Manufacturers Association
Machinery Dealers National Association
Manufacturers Agents National Association
Mechanical Contractors Association of America, Inc.
Menswear Retailers of America
National Association for the Self-Employed
National Association of Brick Distributors
National Association of Catalog Showroom Merchandisers
National Association of Chemical Distributors
National Association of Development Companies
National Association of Home Builders
National Association of Investment Companies
National Association of Manufacturing Opticians
National Association of Personnel Consultants
National Association of Plumbing-Heating-Cooling Contractors
National Association of Realtors
National Association of Retail Druggists
National Association of Small Business Investment Companies
National Association of the Remodeling Industry
National Association of Truck Stop Operators
National Association of Women Business Owners
National Candy Wholesalers Association
National Campground Owners Association
National Chimney Sweep Guild
National Coffee Service Association
National Council for Industrial Innovation
National Electrical Contractors Association
National Fastener Distributors Association
National Grocers Association
National Knitwear & Sportswear Association
National Independent Dairy-Foods Association
National Lumber & Building Material Dealers Association
National Machine Tool Builders' Association
National Moving and Storage Association
National Office Products Association
National Paperbox & Packaging Association
National Parking Association
Professional Plant Growers Association
National Precast Concrete Association
National Shoe Retailers Association
National Society of Public Accountants
National Tire Dealers & Retreaders Association
National Tooling and Machining Association
National Tour Association
National Venture Capital Association
Opticians Association of America
Petroleum Marketers Association of America
Printing Industries of America, Inc.
Professional Plant Growers Association
Retail Bakers of America
Small Business Council of America, Inc.
Smaller Manufacturers Council
Society of American Florists
Specialty Advertising Association International
The National Association of Passenger Vessel Owners
United Bus Owners of America

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Statement of The Tax Council
on
Tax Policy Aspects of Mergers and Acquisitions

submitted to
The Committee on Ways and Means
U.S. House of Representatives
March 2, 1989

The hearings on tax policy and corporate restructuring in late January and early February did not point to a consensus on any legislative changes. This is not surprising, given the uncertainties about what effect LBOs and other restructurings have on the economy and Federal revenues. The Tax Council believes it is prudent to approach the matter with caution, particularly in regard to any tax action to which these comments are limited.

Secretary Brady testified that the tax system has contributed to an overreliance on debt financing and a bias against equity. In his view this should be addressed by alleviating the double taxation of corporate earnings. The Council certainly concurs. Our long-held position has been that such double taxation should be eliminated, both to make more capital available for productive investments and to make equity financed investment more attractive relative to debt. In fact, despite the reduction of the corporate tax rate to 34 percent, multiple taxation of corporate earnings is becoming more oppressive because of the inversion of the individual/corporate rate structure and because of moves to increase the tax penalty on inter-corporate dividends. And just because we have lived with this double-tax handicap for a long time doesn't mean it is unimportant. Almost all of our international competitors provide effective relief from corporate taxation when dividends are distributed.

Obviously, the revenue cost is a major obstacle in allowing a dividend deduction or shareholder credit now. This has led to proposals to balance dividend relief with restrictions on interest deductions. Congressman Gradison, for example, has proposed an 80 percent dividend deduction to be offset by a 20 percent interest disallowance. The Joint Committee on Taxation apparently has estimated this to be a rough wash in revenues. As much as we would like to move forward on alleviating the double taxation of corporate earnings, we are concerned that such sweeping moves could prove counterproductive and that static revenue neutrality by itself is not a sufficient virtue.

Many corporations are simply not in a position to issue equity. A blanket cutback in interest deductibility would raise their cost of capital and could have significant discriminatory effects between corporations and industrial sectors. There is no reason to discourage investment just because it is debt financed.

It has been suggested that restrictions on interest deductions could be narrowly drawn to certain takeover situations. This would limit the potential damage to investment. But the problem with all such proposals, aside from additional administrative complexity, is in trying to distinguish legislatively between what investment or acquisition is good for the economy and what isn't. In fact, it is far from certain that LBOs involve a net revenue loss to the Treasury. There are offsetting factors to the increase in corporate interest payments, which, in numerous cases, may produce a net revenue gain. Nor, as brought out in Secretary Brady's written statement, should the recent growth in LBOs "be seen as driven only by tax considerations." Takeover activity may be affected far more by other financial considerations.

It's certainly unlikely that any narrowly drawn legislative proposal to restrict interest deductions with respect to LBOs or other restructurings would provide sufficient new revenue to finance a meaningful dividend deduction or shareholder credit. About the only certainty with such interest restrictions is that they would encourage more takeovers of U.S. firms by foreign investors who would not be similarly disadvantaged.

For these reasons, we believe alleviation of double taxation of corporate earnings should not be linked to interest restrictions on LBOs or other restructurings. For the future, a phased-in dividend deduction or shareholder credit should help bring about a better balance in debt/equity ratios generally, but this should be considered on its own merits and in the context of overall fiscal policy.

STATEMENT OF THE TRUCK RENTING AND LEASING ASSOCIATION ON THE TAX POLICY ASPECTS OF MERGERS AND ACQUISITIONS BEING CONSIDERED BY THE HOUSE COMMITEE ON WAYS AND MEANS

The House Committee on Ways and Means as well as The Senate Finance Committee and U.S. Treasury are all currently studying the impact of leveraged buyouts (LBOs) on the economy and potential legislative actions that would affect LBOs.

One measure being given serious consideration is the full or partial elimination of tax deductions for interest expense.

The Truck Renting and Leasing Association (TRALA) wishes to state for the record its position on this particular measure.

TRALA is a national association representing an industry of over 3200 companies operating a rental and lease fleet of approximately 1.2 million trucks.

Companies which comprise TRALA's membership are engaged in the business of renting and leasing trucks (including tractor trailers). They are capital intensive and highly leveraged. The business of leasing is in part by its very nature a financial transaction. Because both major and small manufacturing and distributing companies in the United States prefer to avoid the huge capital expenditures incurred by buying a fleet of trucks, which can cost in excess of $80,000 - 100,000 each, and because of the services offered by truck operating lease companies they have found leasing to be a profitable alternative. The security offered by the vehicles themselves and the avoidance of substantial down payments is good for the lessee and concomitantly the security provided by the vehicles and the rental payments allow the lessor to highly leverage his balance sheet. This financial interaction has been the traditional underpinning for the truck leasing industry.

Thus we cannot emphasize too strongly that any attempt to solve or resolve what is perceived to be a problem with LBOs must recognize the intrinsic structure of the truck rental and leasing industry. TRALA's members and equipment lessors should be viewed analogously with banks and other financial institutions. Indiscriminately limiting the availability of tax deductions for interest expense, pegged to a "desirable" debt-to-equity ratio, without regard to the special leverage circumstances of truck lessors, would do serious harm to the truck rental and leasing industry. Congress must be very careful not to defoliate the forest when the goal is to eliminate one type of weed.

Full or partial elimination of the tax deduction for interest expense will:

1. Make debt financing unduly expensive for truck and other equipment lessors.

2. Place truck and equipment lessors at a distinct disadvantage vis a vis banks and other financial institutions who compete with truck lessors for the same business.

TRALA respectfully requests that Congress and Treasury give consideration to the special financing needs of truck and other equipment lessors before enacting legislation or promulgating rules affecting the tax deductibility of interest expense in leveraged buyouts. Any proposals designed to curtail the tax deductibility of interest expense should be crafted to preserve the competitive balance for truck lessors and other financial institutions.

Respectfully submitted.

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